

Wisconsin Tax Treatment of Tax-Option (S) Corporations and Their Shareholders

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IMPORTANT CHANGES

Wisconsin Net Income. Compute Wisconsin net income for taxable years beginning in 2005 using the federal Internal Revenue Code as amended to December 31, 2004, with certain exceptions.

Withholding Required for Nonresident Shareholders. A tax-option (S) corporation that has nonresident shareholders is subject to a withholding tax, unless certain exceptions are met.

Veterans Trust Fund Donation. Corporations may designate any amount of refund due or additional payment for the veterans trust fund.

Early Stage Seed Investment Credit. Shareholders of a tax-option (S) corporation that makes payments to a Department of Commerce qualified fund manager for investment in a qualified new business venture may be eligible for a tax credit.

Farmland Tax Relief Credit. For taxable years beginning on or after January 1, 2005, the credit is 20% of the farmland net property taxes, but not more than \$1,500.

I. INTRODUCTION

This publication is designed to assist a tax-option (S) corporation and its shareholders in preparing their 2005 Wisconsin franchise or income tax returns.

Under federal law, an S corporation is one that has an election in effect for a taxable year under Subchapter S of the Internal Revenue Code which permits the corporation's income to be taxed to its shareholders rather than to the corporation itself, with certain exceptions. If the corporation incurs a loss, the loss is treated as the shareholders' loss. Under Wisconsin law, a tax-option (S) corporation is one that is treated as an S corporation under the federal Internal revenue Code as amended to December 31, 2004, and has not elected out of Wisconsin tax-option status.

CAUTION

The information in this publication reflects interpretations by the Wisconsin Department of Revenue of laws enacted by the Wisconsin Legislature as of December 1, 2005. Laws enacted after this date, new administrative rules, and court decisions may change the interpretations in this publication.

II. DEFINITIONS APPLICABLE TO TAX-OPTION (S) CORPORATIONS

A. Internal Revenue Code

For taxable years that begin in 2005, "Internal Revenue Code" means the federal Internal Revenue Code (IRC) as amended to December 31, 2004, with the exceptions listed below. The Internal Revenue Code generally applies for Wisconsin purposes at the same time as for federal purposes.

Exceptions: The following federal law changes *do not apply* for Wisconsin franchise and income tax purposes:

- Section 13113 of Public Law 103-66, Omnibus Budget Reconciliation Act of 1993, enacted August 10, 1993, relating to the exclusion of 50% of the gain from the sale or exchange of qualified small business stock held more than 5 years.
- Section 1311 of Public Law 104-188, Small Business Job Protection Act of 1996, enacted August 20, 1996, relating to the elimination of earnings and profits from pre-1983 S corporation years from an S corporation's accumulated earnings and profits. Thus, a corporation that was a tax-option (S) corporation for Wisconsin for any taxable year beginning before January 1, 1983, and is a tax-option (S) corporation for its first taxable year beginning after December 31, 1996, may not reduce its accumulated earnings and profits by any amount accumulated in pre-1983 S corporation years. Distributions from pre-1983 tax-option (S) corporation years continue to be taxable as dividends for Wisconsin purposes.
- Sections 1, 3, 4, and 5 of Public Law 106-519, FSC Repeal and Extraterritorial Income Exclusion Act of 2000, enacted November 15, 2000, relating to the allowance of an exclusion for extraterritorial income. Foreign sales corporation (FSC) treatment is repealed for Wisconsin for taxable years beginning on or after January 1, 2005.
- Section 162 of Public Law 106-554, Community Renewal Tax Relief Act of 2000, enacted December 21, 2000, and section 308 of Public Law 108-311, Working Families Tax Relief Act of 2004, enacted October 4, 2004, relating to the expensing of environmental remediation costs and the extension of the termination date.

- Section 165 of Public Law 106-554, Community Renewal Tax Relief Act of 2000, enacted December 21, 2000, and section 306 of Public Law 108-311, Working Families Tax Relief Act of 2004, enacted October 4, 2004, relating to the enhanced deduction for corporate donations of computer technology and the extension of the termination date.
- Public Law 106-573, Installment Tax Correction Act of 2000, enacted December 28, 2000, relating to the restoration of the installment method of accounting for accrual basis taxpayers. For Wisconsin purposes, accrual basis taxpayers cannot use the installment method for reporting sales and other dispositions occurring on or after December 17, 1999. Instead, gain from the sale of property must be recognized in the year of the sale, rather than when the payments are received.
- Section 101 of Public Law 107-147, Job Creation and Worker Assistance Act of 2002, enacted March 9, 2002, section 201 of Public Law 108-27, Jobs and Growth Tax Relief Reconciliation Act of 2003, enacted May 28, 2003, and section 403(a) of Public Law 108-311, Working Families Tax Relief Act of 2004, enacted October 4, 2004, relating to the 30% bonus depreciation allowance for qualified property acquired after September 10, 2001.
- Section 201 of Public Law 108-27, Jobs and Growth Tax Relief Reconciliation Act of 2003, enacted May 28, 2003, relating to the 50% bonus depreciation allowance for qualified property acquired after May 5, 2003.
- Section 202 of Public Law 108-27, Jobs and Growth Tax Relief Reconciliation Act of 2003, enacted May 28, 2003, relating to increased section 179 expensing for small business, and section 201 of Public Law 108-357, American Jobs Creation Act of 2004, enacted October 22, 2004, relating to the extension of the termination date.
- Section 1201 of Public Law 108-173, Medicare Prescription Drug, Improvement, and Modernization Act of 2003, enacted December 8, 2003, relating to health savings accounts.
- Section 244 of Public Law 108-357, American Jobs Creation Act of 2004, enacted October 22, 2004, relating to special rules for certain film and television productions.
- Section 336 of Public Law 108-357, American Jobs Creation Act of 2004, enacted October 22, 2004, relating to the depreciation allowance for aircraft.
- Section 337 of Public Law 108-357, American Jobs Creation Act of 2004, enacted October 22, 2004, relating to the modification of the placed in service rule for purposes of bonus depreciation.
- Section 909 of Public Law 108-357, American Jobs Creation Act of 2004, enacted October 22, 2004, relating to sales or dispositions to implement Federal Energy Regulatory Commission or state electric restructuring policy.
- Section 910 of Public Law 108-357, American Jobs Creation Act of 2004, enacted October 22, 2004, relating to the expansion of the limitation on depreciation of certain passenger automobiles.
- In addition, IRC section 1366(f), relating to the reduction in pass-throughs for taxes at the S-corporation level, is modified by substituting the Wisconsin built-in gains tax for the taxes imposed under IRC sections 1374 and 1375.

Federal law changes enacted after December 31, 2004, won't apply for Wisconsin purposes unless subsequently adopted by the Wisconsin Legislature. For example, Public Law 109-58, Energy Tax Incentives Act of 2005, enacted August 8, 2005, Public Law 109-59, Safe, Accountable, Flexible, Efficient Transportation Equity Act of 2005, enacted August 10, 2005, and Public Law 109-73, Katrina Emergency Tax Relief Act of 2005, enacted September 23, 2005, do not apply for Wisconsin purposes.

For property placed in service in taxable years beginning on or after January 1, 2005, you must compute depreciation or amortization under the Internal Revenue Code as amended to December 31, 2000.

Note: Federal law provides a deduction for 100% of the health insurance costs of self-employed individuals, including 2% shareholder-employees of tax-option (S) corporations. That deduction applies for Wisconsin income tax purposes.

B. S Corporation

To qualify for federal S corporation treatment under the Internal Revenue Code as amended to December 31, 2004, a corporation must meet all of the following requirements:

- It must be domiciled in the United States. That is, it must be created or organized in the United States under federal or state law.
- It must have no more than 100 shareholders.
- It must have as shareholders only individuals, estates, certain tax-exempt organizations, and certain trusts. Qualified retirement plan trusts, as described in IRC section 401(a), and charitable organizations, as described in IRC section 501(c)(3), that are exempt from federal income tax under IRC section 501(a) may be shareholders. Grantor trusts, voting trusts, qualified Subchapter S trusts (QSSTs), electing small business trusts (ESBTs), and, for certain periods of time, former grantor trusts and testamentary trusts may be shareholders. In certain cases, IRAs including Roth IRAs may be shareholders of bank S corporations. Corporations, partnerships, and foreign trusts can't be shareholders.
- It must not have a nonresident alien as a shareholder.
- It must have only one class of stock. A corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distributions and liquidation proceeds. Stock may have differences in voting rights and still be considered one class of stock. Straight debt isn't treated as a second class of stock if certain conditions are met. See the Internal Revenue Code and federal regulations for further details.
- It must not be a financial institution that uses the reserve method of accounting for bad debts; an insurance company taxed under Subchapter L of the Internal Revenue Code; a corporation that takes the tax credit for doing business in a United States possession; or a DISC (domestic international sales corporation), an IC-DISC (interest charge domestic international sales corporation), or a former DISC.
- During the life of the current income beneficiary, there can only be one income beneficiary.
- Corpus distributions during the current income beneficiary's life can only be made to him or her.
- The current income beneficiary's income interest must terminate on the earlier of his or her death or the termination of the trust.
- If the trust terminates during the current income beneficiary's life, the trust's assets must all be distributed to the current income beneficiary.
- All of the trust's income must be distributed, or required to be distributed, currently to the current income beneficiary, who must be an individual who is a citizen or resident of the United States.
- The beneficiary, or the beneficiary's legal representative, elects to have the trust qualify as a QSST.

Note: A trust that qualifies as a QSST for federal purposes under the Internal Revenue Code as amended to December 31, 2004, automatically qualifies as a QSST for Wisconsin. The beneficiary isn't required to make a separate Wisconsin election. The QSST, not its beneficiary, is considered to be the shareholder for purposes of filling out the Wisconsin Schedules 5K-1. The QSST must file Wisconsin fiduciary income tax returns, Form 2, to report its share of the tax-option (S) corporation income, whether or not all of the trust income is distributed. In addition, the beneficiary of the QSST must file Wisconsin individual income tax returns.

D. Electing Small Business Trust (ESBT)

An ESBT must meet all of the following requirements:

- It must have as beneficiaries only individuals, estates, or certain charitable organizations. For taxable years beginning in 1997, charities could hold only contingent interests and couldn't be potential current beneficiaries. Charities may hold current interests for taxable years beginning after 1997.
- Each potential current beneficiary of the trust must be an eligible S corporation shareholder.
- It must not have a QSST election in effect with respect to any stock it holds.

This is a very brief summary of the federal requirements. Refer to IRC section 1361(b), as amended to December 31, 2004, for more details.

C. Qualified Subchapter S Trust (QSST)

A QSST is a trust that meets all of the following requirements:

- It cannot be a tax-exempt trust, a charitable remainder trust, or charitable remainder unitrust.
- No interests in the trust were acquired by purchase.
- The trustee elects to have the trust qualify as an ESBT.

Note: A trust that qualifies as an ESBT for federal purposes under the Internal Revenue Code as amended to December 31, 2004, automatically qualifies as an ESBT for Wisconsin. The trustee isn't required to make a separate Wisconsin election. For Wisconsin purposes, the portion of an ESBT that consists of stock of one or more tax-option (S) corporations is treated as a separate trust, the same as for federal purposes. The Wisconsin net income for that portion is determined under IRC section 641(d), as modified by sec. 71.05(6) to (12), (19), and (20), Wis. Stats. The separate trust is taxed on its Wisconsin taxable income at the highest Wisconsin income tax rate applicable to trusts. The remainder of the trust is taxed the same as any other trust.

E. Qualifying Subchapter S Subsidiary (QSub)

A QSub is a corporation that meets all of the following requirements:

- It is created or organized in the United States or under the laws of the United States or any state.
- It is not an ineligible type of corporation, as defined in IRC section 1361(b)(2).
- 100% of its stock is held by an S corporation.
- The S corporation elects to treat the corporation as a QSub.

Note: A subsidiary that qualifies as a QSub for federal purposes under the Internal Revenue Code as amended to December 31, 2004, is automatically treated as a QSub for Wisconsin. The S corporation isn't required to make a separate Wisconsin election, nor is it permitted to make a different election for Wisconsin. The QSub will be disregarded as a separate entity for Wisconsin purposes, the same as for federal purposes. Its assets, liabilities, and items of income, deduction, and credit will be treated as those of the parent tax-option (S) corporation.

For purposes of reporting and collecting Wisconsin sales and use taxes, the owner of a QSub must report

taxable sales and purchases of the QSub on the owner's sales and use tax return. However, for other sales and use tax purposes, a QSub is an entity separate from its owner. The transfer of ownership to, possession of, title to, or enjoyment of property between these separate legal entities is a "sale," as defined in sec. 77.51(14), Wis. Stats.

F. Tax-Option (S) Corporation

For Wisconsin purposes, a "tax-option (S) corporation" is defined as a corporation which is treated as an S corporation under Subchapter S of the Internal Revenue Code as amended to December 31, 2004, and has not elected out of tax-option corporation status under sec. 71.365(4)(a), Wis. Stats., for the current taxable year.

III. YEARS TO WHICH WISCONSIN'S TAX-OPTION (S) CORPORATION LAW APPLIES

A. 1978 and Prior Taxable Years

For corporations' taxable years ending on or before June 30, 1979, Wisconsin law didn't permit corporations to elect Subchapter S treatment for Wisconsin purposes. A corporation electing Subchapter S status for federal purposes was taxed as a regular (C) corporation for Wisconsin.

B. 1979 Through 1986 Taxable Years

For corporations' taxable years ending from July 31, 1979, through June 30, 1987, Wisconsin recognized tax-option (S) corporation status. A corporation that elected and qualified federally to be treated as a Subchapter S corporation was required to be treated as a tax-option (S) corporation for Wisconsin tax purposes. However, a tax-option (S) corporation and its shareholders determined and reported their incomes under special Wisconsin rules.

A tax-option (S) corporation computed its net income or net loss under the same Wisconsin corporate franchise or income tax law applicable to regular (C) corporations that filed Wisconsin franchise or income tax returns. A tax-option (S) corporation didn't pay a Wisconsin franchise or income tax if the corporate net income was reported by its shareholders. If the corporation incurred a net loss for the year, the loss was treated as the shareholders' loss.

For Wisconsin tax purposes, unlike for federal tax purposes for taxable years beginning after December 31, 1982, tax-option (S) corporations weren't treated as pass-through entities similar to partnerships. Instead, corporate income or loss retained its character as business income or loss and didn't flow through as individual items of income, expense, or capital gain or loss.

C. 1987 Taxable Year and Thereafter

For corporations' taxable years ending on or after July 31, 1987, the Wisconsin tax-option (S) corporation law is federalized; that is, based on the federal Internal Revenue Code. Federal S corporations that are treated as Wisconsin tax-option corporations compute their Wisconsin income under the Internal Revenue Code in effect for Wisconsin purposes.

In addition, tax-option (S) corporations are now treated as pass-through entities similar to partnerships, the same as for federal purposes. Items of income, loss, and deduction retain their character as business income or loss but pass through to the shareholders and are included in the shareholders' returns as if received or accrued, paid or incurred directly by the shareholders.

The federalized tax-option (S) law applies beginning with the shareholder's 1987 or 1988 taxable year, as appropriate to conform the shareholder's treatment of income, loss, and deductions to the tax-option (S) corporation's treatment.

Because all tax-option items retain their character as business income or loss, a nonresident shareholder's share, as well as a resident's share, of a tax-option (S) corporation's intangible income, except interest on United States government obligations, bonds issued by the government of Puerto Rico, and certain state and municipal government bonds, continues to be taxable by Wisconsin.

D. Taxable Years Beginning On or After January 1, 1997

If a federal S corporation elects to treat a subsidiary as a qualified Subchapter S subsidiary (QSub) for federal purposes, that election automatically applies for Wisconsin purposes. The QSub is disregarded as a separate corporation for Wisconsin purposes, and its assets, liabilities, and items of income, deduction, and credit are treated as those of the parent tax-option (S)

corporation. If Wisconsin has jurisdiction to impose franchise or income taxes on the QSub, Wisconsin has jurisdiction to impose these taxes on the parent tax-option (S) corporation.

When a parent corporation elects to treat a subsidiary as a QSub and the tax treatment is determined under Subchapter C of the Internal Revenue Code for federal purposes, that same treatment applies for Wisconsin.

If a tax-option (S) corporation is the sole owner of any entity, such as a limited liability company, that is disregarded as a separate entity under IRC section 7701, the entity is disregarded as a separate entity for Wisconsin franchise and income tax purposes, and its income is reportable by the tax-option (S) corporation.

IV. CORPORATIONS SUBJECT TO WISCONSIN'S TAX-OPTION (S) LAW

Corporations that are required to file Wisconsin franchise or income tax returns and are included in the definition of a "tax-option (S) corporation," as described in Part II.F, are subject to Wisconsin's tax-option (S) corporation law.

Corporations that must file Wisconsin franchise or income tax returns include:

- Corporations organized under Wisconsin law.
- Foreign corporations licensed to do business in Wisconsin.
- Unlicensed corporations doing business in Wisconsin.
- Foreign corporations engaged in buying or selling lottery prizes if the winning tickets were originally bought in Wisconsin.
- Foreign corporations issuing credit, debit, or travel and entertainment cards to customers in Wisconsin.
- Foreign corporations owning, directly or indirectly, a general or limited partnership interest in a partnership that does business in Wisconsin, regardless of the percentage of ownership.
- Foreign corporations owning, directly or indirectly, an interest in a limited liability company treated as a partnership that does business in Wisconsin, regardless of the percentage of ownership.
- Foreign corporations that are the sole owner of an entity that is disregarded as a separate entity under IRC section 7701 and does business in Wisconsin.

- Foreign S corporations that have a QSub that does business in Wisconsin.

A. Electing Tax-Option (S) Corporation Status

Under IRC section 1362 as amended to December 31, 2004, only those corporations that have elected and qualify for S corporation status are treated as S corporations. The election is valid only if all persons who are shareholders on the day on which the election is made (and in the case of retroactive elections described in the following paragraph, who were shareholders prior to the election during that 2 1/2 month period) consent to the election. If the stock is held as community property or if the income from the stock is community property, the consent must be signed by both husband and wife. The Internal Revenue Service has determined that Wisconsin's marital property is a form of community property.

A corporation may make a federal S corporation election at any time during the preceding taxable year or at any time during the first 2 1/2 months of the taxable year. If the election is made after the 15th day of the 3rd month of the taxable year, or if any of the other conditions aren't satisfied, the election won't take effect until the first day of the following year. The same effective date applies for Wisconsin purposes as for federal purposes.

To be treated as a tax-option corporation for Wisconsin, a corporation isn't required to file a separate election form with the Wisconsin Department of Revenue. Wisconsin's tax-option (S) corporation law automatically applies to a corporation under Wisconsin's jurisdiction for franchise or income tax purposes if it has an election in effect under Subchapter S of the Internal Revenue Code as amended to December 31, 2004, for a taxable year, unless the corporation has elected out of Wisconsin tax-option status under sec. 71.365(4)(a), Wis. Stats., as described in Part VI.B. However, if an S corporation has a QSub, neither the corporation nor the QSub may elect out of Wisconsin tax-option (S) status.

Under IRC sections 1362(b)(5) and (f)(1)(A) as amended to December 31, 2004, a corporation can be treated as qualifying for S status despite making a late election. Such treatment also applies for Wisconsin purposes.

B. Special Rules When Converting Existing Regular (C) Corporations

Special rules apply to regular (C) corporations that elect to be tax-option (S) corporations.

1. Wisconsin Built-in Gains Tax

Generally, regular (C) corporations electing S corporation status after 1986 are subject to a federal corporate level tax on the "built-in gain" recognized during the first ten years after the election is made. These corporations may also be subject to a Wisconsin built-in gains tax as described in Part VII.D.2.

The Wisconsin built-in gains tax also may apply to a federal S corporation that has elected not to be a tax-option (S) corporation for Wisconsin purposes and subsequently re-elects Wisconsin tax-option (S) corporation status.

2. Recapture of LIFO Benefits

Under federal law, a regular (C) corporation that maintains its inventory under the last-in, first-out (LIFO) method and elects S corporation status after December 17, 1987, must include in income for its last taxable year as a regular (C) corporation the "LIFO recapture amount." The LIFO recapture amount is the excess of the inventory's value under the first-in, first-out (FIFO) method over its LIFO value as of the close of its last year as a C corporation. The extra tax attributable to the LIFO recapture amount is payable in equal installments over a four-year period.

For Wisconsin purposes, the LIFO recapture amount is also includable in the corporation's net income for its last taxable year as a regular (C) corporation. However, unlike for federal purposes, the additional tax attributable to the LIFO recapture amount can't be spread over four years. The entire amount is payable by the unextended due date of the return for the last year as a C corporation.

3. Corporate Preference Addbacks

If an S corporation was a regular (C) corporation for any of the three immediately preceding taxable years, federal law requires the S corporation to adjust certain tax preference items in comput-

ing taxable income. For example, the amount of capital gain on the disposal of section 1250 property must be reduced by 20%, the amortizable basis of pollution control facilities must be reduced by 20%, and the deduction for intangible drilling and mineral exploration and development costs generally must be reduced by 30%. This same treatment applies for Wisconsin purposes.

V. SHAREHOLDERS SUBJECT TO WISCONSIN'S TAX-OPTION (S) LAW

A. Shareholders of Tax-Option (S) Corporations That Are Subject to Wisconsin's Tax-Option (S) Law

Wisconsin's tax-option (S) corporation law applies to all shareholders of a tax-option (S) corporation that is subject to Wisconsin tax-option (S) corporation law, whether or not the shareholders are Wisconsin residents. This includes —

- Shareholders of a tax-option (S) corporation which is organized under the laws of Wisconsin and engaged in business (1) completely in Wisconsin, (2) in and outside Wisconsin, or (3) completely outside Wisconsin.
- Shareholders of a tax-option (S) corporation which isn't organized under the laws of Wisconsin but which is authorized to transact business in Wisconsin or is engaged in business in Wisconsin and required to file a Wisconsin franchise or income tax return.

Therefore, all shareholders who meet the applicable Wisconsin filing requirements, after taking into account their pro rata shares of the corporation's gross income for Wisconsin purposes, must file Wisconsin income tax returns and report their pro rata shares of the tax-option (S) corporation's items of income, loss, and deduction.

"Gross income" of a tax-option (S) corporation includes gross receipts or sales, gross rents and royalties, interest and dividends, and the gross sales price of capital assets and property used in a trade or business. The shareholder's share of the corporation's Wisconsin gross income is reported on Wisconsin Schedule 5K-1, line 18, column d (column e for non-residents and part-year residents of Wisconsin).

If any shareholder who is required to file a Wisconsin income tax return fails to file and include in Wisconsin

taxable income his, her, or its share of tax-option items of income, the Department of Revenue may tax the tax-option (S) corporation on that shareholder's share of the corporation's net income.

Note: For taxable years beginning after December 31, 1997, federal law no longer treats an S corporation's items of income and loss as unrelated business taxable income when the S corporation's stock is held by an employee stock ownership plan (ESOP) maintained by the corporation. The same treatment applies for Wisconsin purposes. As a result, the ESOP is not subject to Wisconsin franchise or income tax on its share of the tax-option (S) corporation's income. The tax-option (S) corporation is allowed a deduction equal to the ESOP's share of income, resulting in no franchise or income tax to the tax-option (S) corporation.

A tax-option (S) corporation may file a composite individual and fiduciary income tax return on behalf of qualifying nonresident shareholders, as explained in Part IX.G.

B. Shareholders of S Corporations That Aren't Subject to Wisconsin's Jurisdiction

Wisconsin resident shareholders of S corporations that aren't subject to Wisconsin's jurisdiction for franchise or income tax purposes are also subject to Wisconsin tax-option (S) law. See Part IX.F for a description of the income or loss reportable by Wisconsin resident shareholders from these corporations.

VI. TERMINATION OF TAX-OPTION (S) TREATMENT

Once an S corporation election is made, it continues in effect as long as the corporation is in existence, unless S corporation status is terminated. The corporation's S status may be terminated by revoking the election, by violating the passive investment income restrictions, or by ceasing to qualify as an S corporation under the Internal Revenue Code as amended to December 31, 2004. Wisconsin tax-option (S) treatment continues to apply as long as the federal S corporation election is in effect, unless the corporation elects not to be a tax-option (S) corporation for Wisconsin purposes.

A. Termination Under the Internal Revenue Code

A corporation ceases to qualify for Wisconsin tax-option (S) treatment for any year for which its S corporation election ceases to apply, regardless of

whether the termination is voluntary or involuntary, or whether termination is discovered as the result of an audit after a return has been filed.

1. Voluntary Termination

Under the Internal Revenue Code as amended to December 31, 2004, a corporation may voluntarily revoke its S election at any time after the initial election is made. The revocation may be effective for the entire taxable year if made on or before the 15th day of the 3rd month of that taxable year. Otherwise, it may be effective for the following taxable year. In either case, the revocation may specify that it is to be effective on a date during the current year that is on or after the day of revocation.

2. Involuntary Termination

A corporation's Subchapter S status under the Internal Revenue Code as amended to December 31, 2004, will be involuntarily terminated for federal and, therefore, also for Wisconsin purposes if —

- The corporation was an S corporation and had accumulated Subchapter C earnings and profits at year-end and its passive investment income exceeded 25% of gross receipts for each of three consecutive taxable years. The election is terminated as of the first day of the taxable year beginning after the third consecutive taxable year in which there is excess passive investment income.
- The corporation ceases to be a qualifying Subchapter S corporation as described in Part II.B. The Internal Revenue Service may waive inadvertent termination and this waiver also applies for Wisconsin.

If the revocation date causes the corporation's taxable year to be split, the corporation must file two short-period returns for federal and Wisconsin purposes. One covers the period it is an S corporation and one covers the period it is a C corporation. Both returns are due on the 15th day of the 3rd month following the close of the corporation's normal taxable year, subject to the regular rules for extensions. The net income for each period may be computed under the daily proration method as provided in IRC section 1362(e)(2) or under normal tax accounting rules if the affected shareholders consent as provided in IRC section 1362(e)(3). The corporation must use the normal tax

accounting rules if there was a sale or exchange of 50% or more of the corporation's stock during the year.

B. Electing Out of Wisconsin Tax-Option Treatment

Generally, a corporation that is an S corporation for federal tax purposes may elect not to be a tax-option (S) corporation for Wisconsin tax purposes. However, if an S corporation has a QSub for federal income tax purposes, neither the S corporation nor the QSub may opt out of Wisconsin tax-option treatment.

The "opt-out" election requires the consent of persons who hold more than 50% of the shares of the tax-option (S) corporation on the day on which the "opt-out" election is made. To be effective for the current taxable year, the election must be made on or before the due date or extended due date of the corporation's current Wisconsin franchise or income tax return. To make the "opt-out" election, the corporation must file Wisconsin Form 5E, Election by an S Corporation Not to Be Treated as a Tax-Option Corporation.

The "opt-out" election is completed by filing a Wisconsin franchise or income tax return in accordance with the election. A corporation that has made an "opt-out" election must file Form 4 or Form 5 for Wisconsin rather than Form 5S. Since the corporation will be filing Form 1120S for federal purposes, special adjustments, which are explained in the Form 4 or Form 5 instructions, may be required to properly determine Wisconsin net income.

In addition, the shareholders of a corporation that has made an "opt-out" election must make modifications when computing their Wisconsin adjusted gross income and Wisconsin itemized deduction credit. They must eliminate all S corporation items of income, loss, and deduction included in their federal adjusted gross income and add the amount of any distributions received from the corporation.

An S corporation doesn't have to be under Wisconsin's franchise or income tax jurisdiction in order to elect not to be treated as a tax-option corporation for Wisconsin purposes. A corporation that isn't organized under Wisconsin law, isn't authorized to do business in Wisconsin, and isn't engaged in business in Wisconsin may file Form 5E to elect out of Wisconsin tax-option status. Since such a corporation isn't required to file a Wisconsin franchise or income tax return, Form 5E is due by the due date, including ex-

tensions, of the corporation's federal income tax return.

A corporation that files its Wisconsin franchise or income tax return as a tax-option (S) corporation prior to the due date, or extended due date, of the return may later opt out of Wisconsin tax-option corporation status for that taxable year. The corporation must take the following actions *on or before* the due date, or extended due date, of the first return to be affected by the election:

- File Form 5E, Election by an S Corporation Not to Be Treated as a Tax-Option (S) Corporation, and
- File an amended Wisconsin franchise or income tax return, Form 4 or 5, as a regular (C) corporation.

C. Withdrawing the Wisconsin “Opt-Out” Election

An “opt-out” election isn't completed until the corporation has filed its Wisconsin franchise or income tax return for the first taxable year affected by the election. Prior to the due date, or extended due date, for filing that Wisconsin return, the corporation may withdraw its “opt-out” election.

Example 1: A calendar-year federal S corporation files a properly completed Form 5E with the Wisconsin Department of Revenue on January 15, 2006, for the taxable year that began in 2005. In February 2006, before filing its 2005 Wisconsin return, the corporation decides that it wishes to withdraw its “opt-out” election. The corporation may withdraw the election by sending a letter to the Wisconsin Department of Revenue requesting the withdrawal. The letter must contain the signatures of shareholders who hold more than 50% of the shares of the corporation.

Example 2: Assume the facts are the same as in Example 1, except that the corporation files its 2005 Wisconsin return on February 1, 2006, as a regular (C) corporation and then decides that it wishes to withdraw the “opt-out” election. The corporation may withdraw the election if it takes the following actions *on or before* March 15, 2006, the due date of its 2005 Wisconsin return:

- Send a letter, signed by shareholders holding more than 50% of the corporation's stock, to the Wisconsin Department of Revenue requesting the withdrawal of the election, and

- File an amended Wisconsin franchise or income tax return, Form 5S, as a tax-option (S) corporation.

Example 3: Assume the facts are the same as in Example 1, except that the corporation receives a federal extension until September 15, 2006, to file its 2005 federal return. This extends the due date of the corporation's Wisconsin return to 30 days after the federal due date. On June 1, 2006, the corporation files its Wisconsin franchise or income tax return as a regular (C) corporation, but it then decides that it wishes to withdraw the “opt-out” election. The corporation may withdraw the election if it takes the following actions on or before October 15, 2006, the extended due date of its Wisconsin return:

- Send a letter, signed by shareholders holding more than 50% of the corporation's stock, to the Wisconsin Department of Revenue requesting the withdrawal of the election, and
- File an amended Wisconsin franchise or income tax return, Form 5S, as a tax-option (S) corporation.

D. Revoking the Wisconsin “Opt-Out” Election

Except as explained below, once the election not to be a tax-option (S) corporation is completed, the corporation and its successors may not claim Wisconsin tax-option status for the next four taxable years after the taxable year to which the “opt-out” election first applies.

1. Voluntary Revocation

At any time after the five-taxable-year period, the corporation may revoke the “opt-out” election by filing Wisconsin Form 5R, Revocation of Election by an S Corporation Not to Be a Tax-Option Corporation.

Revoking the “opt-out” election requires the consent of persons who hold more than 50% of the shares of the S corporation on the day the revocation is made. The corporation must file Form 5R on or before the due date, including extensions, of the Wisconsin franchise or income tax return for the first taxable year affected by the revocation.

2. Automatic Revocation

The “opt-out” election is automatically revoked for the taxable year in which a federal S corporation acquires a QSub. In this situation, it is not necessary to file Form 5R. The corporation and its QSub must report their income on Wisconsin Form 5S.

VII. THE TAX-OPTION (S) CORPORATION’S WISCONSIN FRANCHISE OR INCOME TAX RETURN

A. Selecting the Taxable Year

For federal income tax purposes, S corporations must use a “permitted year.” A permitted year is a taxable year ending December 31 (a calendar year) or any other accounting period for which the corporation establishes a business purpose to the satisfaction of the Internal Revenue Service. However, an S corporation may elect, under IRC section 444, to have a taxable year other than a required taxable year, provided the corporation makes required tax payments under IRC section 7519 for each year the election is in effect.

Tax-option (S) corporations must adopt the same accounting period for Wisconsin as for federal purposes. Any change in accounting period made for federal purposes must also be made for Wisconsin purposes. If a tax-option (S) corporation elects to have a taxable year other than a required taxable year, that election also applies for Wisconsin. Unlike for federal purposes, the tax-option (S) corporation doesn’t have to make required payments of Wisconsin tax.

B. Adopting an Accounting Method

For Wisconsin purposes, a tax-option (S) corporation must use the same method of accounting used for federal purposes. Any change in accounting method made for federal purposes must also be made for Wisconsin. However, if the accounting method used federally isn’t authorized under the Internal Revenue Code in effect for Wisconsin, the tax-option (S) corporation must use a method authorized under the Internal Revenue Code in effect for Wisconsin.

Adjustments required federally as a result of a change in accounting method made while the corporation is subject to Wisconsin taxation must also be made for

Wisconsin purposes. However, in the last year that a tax-option (S) corporation is subject to taxation by Wisconsin, it must take into account all remaining adjustments required.

Note: A tax-option (S) corporation entitled to use the installment method of accounting must take the unreported balance of gain on installment obligations into income in the taxable year of their distribution, transfer, or acquisition by another person or for the final taxable year for which it files or is required to file a Wisconsin franchise or income tax return, whichever year occurs first.

If a corporation has an option under the Internal Revenue Code that isn’t considered a method of accounting by the Internal Revenue Service, the corporation may make a different election for Wisconsin than that made for federal purposes. If federal law specifies the manner or time period in which such an election must be made, those requirements also apply for Wisconsin purposes.

C. Computing Corporate Income (Loss)

As explained in Part III, the Wisconsin tax-option (S) corporation franchise or income tax law is based on the federal Internal Revenue Code.

1. Computation of Federal Income

For federal purposes, the taxable income of an S corporation generally is computed like the taxable income of an individual with the following differences.

- Any items of income (including tax-exempt income), loss, or deduction, the separate treatment of which could affect the tax liability of any shareholder must be separately stated and passed through to the shareholder. Items which must be separately stated include short- and long-term capital gains and losses, gains and losses from dispositions of property used in a trade or business, interest income, dividend income, royalty income, rental income and expenses, tax-exempt income, charitable contributions, interest expenses on investments, expenses for the production of income, section 179 deductions, and items used in figuring depletion on oil and gas properties.

- Certain items may be deductible by an individual, but not by an S corporation, including personal exemptions, charitable contributions, net operating loss deductions, and depletion deductions for oil and gas wells.
- The S corporation may claim the deduction for corporate organizational costs.
- If an S corporation (or any predecessor) was a regular (C) corporation for any of the three immediately preceding taxable years, the S corporation is required to adjust tax preference items as provided in IRC section 291.
- A corporation that becomes an S corporation generally can't take carryovers from taxable years when it was not an S corporation in years when it is an S corporation (see Part VII.D.2 for an exception to this rule). However, each year the corporation is an S corporation counts as a year for the purpose of figuring the years to which carryovers can be taken.

2. Additions To and Subtractions From Federal Income

Additions to or subtractions from federal income may be required for the following items:

- Adjustments required because the federal amount was computed using a provision of the Internal Revenue Code that doesn't apply for Wisconsin purposes.

Example: Certain federal law changes enacted before December 31, 2004, and any changes enacted after that date, generally don't apply for Wisconsin purposes. See Part II.A for details.

- Differences between the federal and Wisconsin deductions for depreciation or amortization.

For assets first placed service in taxable years beginning on or after January 1, 2001, compute depreciation or amortization under the Internal Revenue Code as amended to December 31, 2000.

For qualified property acquired after September 10, 2001, you may not claim the federal 30% bonus depreciation. The 50% additional

first-year depreciation deduction may not be claimed for 50% bonus property acquired after May 5, 2003.

An asset placed in service before 2005 must continue to be depreciated or amortized under the method allowable for Wisconsin purposes for the year in which it was placed in service.

Many differences in Wisconsin and federal depreciation and amortization existed before January 1, 1987. These differences are summarized in the instructions for preparing the tax-option (S) corporation franchise or income tax return, Form 5S.

- Differences between the federal and Wisconsin bases of assets disposed of during the taxable year.

Example: During the current taxable year, a corporation sold the following assets, which had been held more than one year:

	Selling Price	Wisconsin Basis	Federal Basis
Building	\$200,000	\$150,000	\$120,000
Machinery	15,000	5,000	17,500
Equipment	1,000	1,500	500

The gains (losses) realized on these transactions are —

	Wisconsin Gain (Loss)	Federal Gain (Loss)
Building	\$50,000	\$80,000
Machinery	10,000	(2,500)
Equipment	(500)	500
Total	<u>\$59,500</u>	<u>\$78,000</u>

For federal purposes, the \$500 gain on the sale of the equipment is determined to be depreciation recapture, which is treated as ordinary gain and included in the corporation's ordinary income or loss on Form 5S, Schedule 5K, line 1, column b.

The corporation must recompute a federal Form 4797, substituting the Wisconsin depreciation allowed or allowable and the

Wisconsin basis of the assets for the federal amounts.

For Wisconsin purposes, \$5,000 of the gain on the sale of the machinery is determined to be depreciation recapture, which is treated as ordinary gain.

The corporation enters \$4,500 (\$5,000 Wisconsin ordinary gain minus \$500 federal ordinary gain) on Schedule 5K, line 1, column c. The corporation makes the following entries on Schedule 5K, line 9: \$77,500 in column b, \$(23,000) in column c, and \$54,500 in column d.

- Adjustments required as a result of making different elections for federal and Wisconsin purposes.

Example 1: The federal work opportunity tax credit and federal research credit are allowed instead of deductions for wages and research expenses, respectively. For Wisconsin purposes, the corporation may elect not to reduce wages and research expenses by the amount of these credits.

Example 2: For federal purposes, shareholders may claim either a credit or a deduction for foreign income taxes paid by a tax-option (S) corporation. For Wisconsin purposes, the foreign taxes may be deductible as provided under the Internal Revenue Code.

- An addition on Schedule 5K, line 1, for the sum of the corporation's manufacturer's sales tax credit computed from Schedule Z, line 10, the total credits passed through from other entities from Schedule Z-1, column e, plus any pre-1998 credit carryover claimed on Form 5S, line 5.
- In addition, on Schedule 5K, line 1, for dairy investment credit computed on Wisconsin Schedule DI, line 7.
- An addition on Schedule 5K, line 1, for development zones credit computed on Wisconsin Schedule DC, line 5.
- An addition, on Schedule 5K, line 1, for development opportunity zone investment credit computed on Wisconsin Schedule DC, line 13.

- An addition, on Schedule 5K, line 1, for development opportunity zone or agricultural development zone capital investment credit computed on Wisconsin Schedule DC, line 21.
- An addition, on Schedule 5K, line 1, for technology zone credit computed on Wisconsin Schedule TC, line 6.
- An addition, on Schedule 5K, line 1, for early stage seed investment credit computed on Wisconsin Schedule VC, line 8.
- An addition, generally on Schedule 5K, line 1, for taxes imposed by Wisconsin, any other state, and the District of Columbia that are value-added taxes, single business taxes, or taxes on or measured by all or a portion of net income, gross income, gross receipts, or capital stock and that were deducted in computing federal income.

Note: You must also show nondeductible taxes as additional nondeductible expenses on Schedule 5K, line 16c.

Example 1: The Internal Revenue Service has determined that for federal purposes Wisconsin's recycling surcharge is a state tax within the meaning of IRC section 164(a). Therefore, it may be deductible as provided under section 164. The amount deductible for federal purposes must be added back to federal income to arrive at Wisconsin income.

Example 2: A tax-option (S) corporation does business in Wisconsin and in another state that doesn't recognize its S status. The corporation pays \$5,000 of franchise tax to the other state, which it deducts in computing federal ordinary income as shown on Schedule 5K, line 1, column b. The \$5,000 must be shown as an addition to income on Schedule 5K, line 1, column c, and as an increase in the amount of nondeductible expenses on Schedule 5K, line 16c, column c.

- Adjustments on the appropriate line of Schedule 5K if the tax-option (S) corporation owes a federal built-in gains tax or a Wisconsin built-in gains tax. For Wisconsin purposes, the gain on the sale of an asset is reduced by any Wisconsin built-in gains tax

paid by the corporation on that asset. For federal purposes, however, the gain is reduced by the federal built-in gains tax.

Example: For 2005, a tax-option (S) corporation has net gain under section 1231 of \$50,000. The corporation owes \$7,000 of federal built-in gains tax and \$1,580 of Wisconsin built-in gains tax on built-in gain reflected in such section 1231 gain. On Schedule 5K, line 9, column b, the corporation enters \$43,000 (\$50,000 net gain minus \$7,000 federal built-in gains tax). The Wisconsin amount to enter in column d is \$48,420 (\$50,000 net gain minus \$1,580 Wisconsin built-in gains tax). The adjustment in column c is \$5,420, which is the difference between the federal and Wisconsin built-in gains taxes.

- Additions on the appropriate line of Schedule 5K for any federal capital gains tax that reduced the tax-option (S) corporation's long-term capital gain and for any federal excess net passive income tax that reduced items of passive investment income for federal purposes.
- Any other adjustments to federal income.

D. Taxing a Tax-Option (S) Corporation

A tax-option corporation is subject to a franchise or income tax only in the following instances.

1. Franchise Tax Measured by Federal, State, and Municipal Government Interest

A tax-option (S) corporation is subject to a franchise tax measured by interest income received from the following obligations:

- Obligations of the United States government and its instrumentalities.
- Municipal housing authority bonds issued under sec. 66.1201, Wis. Stats.
- Municipal redevelopment authority bonds issued under sec. 66.1333, Wis. Stats.
- Housing and community development authority bonds issued under sec. 66.1335, Wis. Stats.

- Bonds issued by the Wisconsin Housing and Economic Development Authority (WHEDA) under sec. 234.65, Wis. Stats., to fund an economic development loan to finance construction, renovation, or development of property that would be exempt from property tax under sec. 70.11(36), Wis. Stats. (professional sports and entertainment home stadiums).
- Bonds issued by a local exposition district under subch. II of ch. 229, Wis. Stats.
- Bonds issued under sec. 66.0621, Wis. Stats., by a local professional baseball park district, a local professional football stadium district, or a local cultural arts district.
- Bonds issued on or after January 1, 2004, by the Wisconsin Housing and Economic Development Authority under sec. 234.08 or 234.61, Wis. Stats., to fund multifamily affordable housing projects or elderly housing projects.

The tax is 7.9% of the interest attributable to Wisconsin.

The corporation may reduce the amount of interest income by any applicable amortizable bond premium or interest paid to purchase or hold these federal, state, or municipal government obligations.

If a foreign corporation is subject to the income tax rather than the franchise tax, it isn't taxed on interest received from the government obligations listed above.

The types of federal, state, and municipal government interest income listed above are separately stated items. They aren't taxable to the shareholders. Any related amortizable bond premium or interest paid to purchase or hold these government obligations isn't deductible by the shareholders.

Note: The franchise tax doesn't apply to interest income on obligations issued by the government of Puerto Rico.

2. Wisconsin Built-In Gains Tax

A tax-option (S) corporation may be liable for a tax on built-in gains if —

- a. It was a regular (C) corporation before making its current election to be treated as a tax-option (S) corporation,
- b. It made its current election after 1986,
- c. It has a recognized built-in gain within ten years from the first day of the first taxable year it became a tax-option (S) corporation under its current election (the recognition period), and
- d. The net recognized built-in gains for prior taxable years don't exceed the net unrealized built-in gain, as defined below.

A **recognized built-in gain** is any gain recognized by a tax-option (S) corporation during the recognition period on the sale or distribution (disposition) of any asset, except to the extent the corporation establishes that —

- a. The asset wasn't held by it on the first day of the first year that the current tax-option (S) election became effective, or
- b. The recognized gain on any asset exceeds the excess of the fair market value of the asset on the date of conversion over the adjusted basis of the asset on that first day.

A **recognized built-in loss** is any loss recognized during the recognition period on the disposition of any asset to the extent the corporation establishes that —

- a. It owned the asset on the date that the current tax-option (S) election became effective, and
- b. The loss doesn't exceed the excess of the asset's adjusted basis on that date over its fair market value at that time.

The net recognized built-in gain on which the tax may be imposed is limited by the corporation's net unrealized built-in gain.

The **net unrealized built-in gain** is the excess of the fair market value of the corporation's assets over the aggregate adjusted bases of those assets on the date the current tax-option (S) election became effective.

For purposes of determining recognized built-in gain, recognized built-in loss, and net unrealized built-in gain for Wisconsin built-in gains tax purposes, the Wisconsin basis of assets should be used, if different from the federal basis.

The built-in gains tax is 7.9% times the lesser of —

- a. The net recognized built-in gain, subject to the net unrealized built-in gain limit, of the tax-option (S) corporation for the taxable year, or
- b. The amount that would be the taxable income of the corporation for the taxable year if the corporation were a regular (C) corporation. Net business loss carryforwards or capital loss carryforwards aren't used in figuring taxable income.

For a corporation that does business in and outside Wisconsin, the amounts in **a** and **b** above are the total amounts (before allocation or apportionment) as determined under Wisconsin law. The lesser of these amounts is then multiplied by the corporation's apportionment percentage for the current year to arrive at the amount subject to the 7.9% Wisconsin tax.

Note: If the net recognized built-in gain computed in **a** above exceeds the amount that would have been the corporation's taxable income in **b**, the excess is treated as a recognized built-in gain in the succeeding taxable year. This carryover provision applies only in the case of a corporation that made its tax-option (S) election on or after March 31, 1988.

Although tax-option (S) corporations normally aren't allowed a deduction for Wisconsin net business loss carryforwards from years when the corporation was a regular (C) corporation, such losses are allowed against the lesser of the amounts described above. In addition, any capital loss carryfor-

ward from a regular (C) corporation year may be used to the extent deductible in arriving at taxable income for regular (C) corporation purposes.

Except for Wisconsin community development finance credit from the current year, as well as carryforwards of that credit from prior regular (C) corporation years, no credits may offset the tax on built-in gains.

If a corporation begins doing business in Wisconsin in a year following the year in which its federal S election became effective, the “recognition period,” “recognized built-in gain,” “recognized built-in loss,” and “net unrealized built-in gain” are the amounts determined under federal law.

3. Tax on Net Income of a Tax-Option (S) Corporation

Since each shareholder of a tax-option (S) corporation who meets the applicable Wisconsin filing requirements is required to file a Wisconsin income tax return and report his, her, or its share of the corporation’s income, loss, and deductions, a tax-option (S) corporation generally isn’t subject to a corporate income tax or franchise tax measured by its net income, other than interest income from certain federal, state, and municipal government obligations.

However, a tax-option (S) corporation may be taxed on a nonfiling or delinquent shareholder’s share of the corporation’s net income. If a tax-option (S) corporation and its shareholders have unreported Wisconsin income, the Department of Revenue will assess the shareholders for the amount of unreported income when the shareholders’ taxable years are still open under the statute of limitations. When the shareholders’ taxable years are closed under the statute of limitations, the Department of Revenue may assess the corporation for the unreported income provided the corporation’s taxable years are still open to adjustment. A tax-option (S) corporation cannot offset a net operating loss carryforward from a year when it was a regular (C) corporation against a nonfiling or delinquent shareholder’s share of the corporation’s income.

4. Wisconsin’s Recycling Surcharge

A recycling surcharge applies to tax-option (S) corporations that are required to file Wisconsin franchise or income tax returns, with certain exceptions. The surcharge doesn’t apply to —

- Corporations organized under Wisconsin law that don’t have any business activities in Wisconsin.
- Corporations not organized under Wisconsin law that don’t have nexus with Wisconsin. “Nexus” refers to the degree of activity necessary before a state has jurisdiction to impose an income tax or franchise tax measured by net income on the taxpayer.
- Corporations that have less than \$4 million of gross receipts from all activities. “Gross receipts from all activities” means gross receipts, gross sales, gross dividends, gross interest income, gross rents, gross royalties, the gross sales price from the disposition of capital assets and business assets, gross receipts passed through from other entities, and all other receipts that are included in gross income for Wisconsin franchise or income tax purposes.

A portion of the recycling surcharge payments collected, including interest and penalties, is deposited in Wisconsin’s recycling fund. These revenues are used to fund grants to county and municipal governments for implementing recycling programs and other solid waste reduction efforts.

The recycling surcharge is the greater of \$25 or 0.2% (0.002) of the corporation’s Wisconsin net income, but not more than \$9,800.

Wisconsin net income for a tax-option (S) corporation doing business only in Wisconsin is the amount from 2005 Wisconsin Schedule 5K, line 17e, column d. For a corporation engaged in business in and outside Wisconsin, **Wisconsin net income** is the portion of the amount on Schedule 5K, line 17e, column d, which is attributable to Wisconsin. Unitary, multistate corporations determine the net income attributable to Wisconsin using the apportionment method. Nonunitary, multistate corporations use separate account-

ing. The net income generally includes interest income from federal, state, and local government obligations.

The recycling surcharge is payable by the 15th day of the 3rd month following the close of the taxable period, regardless of the due date of the corporation's Wisconsin franchise or income tax return.

If the surcharge is delinquent, the corporation's shareholders are jointly and severally liable for it.

5. Withholding Requirement for Tax-Option (S) Corporations Having Nonresident Shareholders

In general, a tax-option (S) corporation that has one or more nonresident shareholders is required to withhold income or franchise tax on the income allocable to the nonresident shareholders.

A nonresident shareholder includes an individual who is not domiciled in Wisconsin and an estate or a trust that is a nonresident under sec. 71.14(1) to (3m), Wis. Stats. The withholding rate is the highest rate for a single individual under sec. 71.06, Wis. Stats.

Exceptions: Withholding is not required on behalf of the following nonresident shareholders:

- A shareholder that is exempt from Wisconsin income or franchise taxation. The tax-option (S) corporation may rely on a written statement from a shareholder explaining why the shareholder is exempt from Wisconsin tax.
- A shareholder with no Wisconsin income other than his, her, or its share of income attributable to Wisconsin, and his, her, or its share of that income is less than \$1,000.

The tax-option (S) corporation uses Form PW-1 to pay the withholding. Form PW-1 is due with payment by the 15th day of the 3rd month following the close of the corporation's taxable year. It must be filed, and payment must be made, by electronic means unless electronic filing and payment presents an undue hardship. See the Form PW-1 instructions for details of the filing procedures.

Nonresident shareholders having a Wisconsin filing requirement must file the appropriate Wisconsin income or franchise tax return.

6. Endangered Resources Donation

A tax-option (S) corporation is allowed to designate any amount of refund due or additional payment for the endangered resources program. Donations support the preservation and management of more than 200 endangered and threatened Wisconsin plants and animals. It also helps protect Wisconsin's finest remaining examples of prairies, forests, and wetlands.

7. Veterans Trust Fund Donation

A tax-option (S) corporation may designate an amount as a veterans trust fund donation. Donations will be used by the Wisconsin Department of Veterans Affairs for the benefit of veterans or their dependents.

E. Making Corporate Estimated Tax and Recycling Surcharge Payments

If the total of a tax-option (S) corporation's net franchise tax measured by certain federal, state, and municipal government interest and recycling surcharge due is \$500 or more, it generally must make quarterly estimated tax payments using Wisconsin Form 4-ES or by electronic funds transfer.

However, a corporation isn't required to make estimated tax payments to prepay the Wisconsin built-in gains tax. The built-in gains tax is payable in full within 2 1/2 months after the end of the corporation's taxable year.

F. Preparing the Return, Form 5S

A tax-option (S) corporation must report its income, loss, and deductions on Wisconsin Form 5S. All appropriate lines on the form, including Schedules 5K and 5M, must be completed.

In addition, the corporation must complete a Wisconsin Schedule 5K-1, Wisconsin Tax-Option (S) Corporation Shareholder's Share of Income, Deductions, etc., for each shareholder.

Exception: If the corporation does business only in Wisconsin and has no adjustments in column c or

Wisconsin credits in column d of Schedule 5K, it isn't necessary to prepare a Wisconsin Schedule 5K-1 for each shareholder. In addition, a Schedule 5K-1 isn't required for a full-year Wisconsin resident shareholder of a corporation that does business in and outside Wisconsin provided there aren't any Wisconsin adjustments or credits. **Be sure to state on the shareholders' federal Schedules K-1, including the copies filed with the Department of Revenue, that there aren't any Wisconsin adjustments or credits.**

The corporation must attach a complete copy of federal Form 1120S and all accompanying schedules and Wisconsin Schedules 5K-1, if required, to the Form 5S that it files with the Department of Revenue.

G. Computing Wisconsin Income of Multistate Corporations Having Only Wisconsin Resident Shareholders

A tax-option (S) corporation deriving its income in and outside Wisconsin and having only Wisconsin resident shareholders doesn't allocate its income, loss, and deductions between Wisconsin and elsewhere when completing Wisconsin Schedules 5K-1 for its shareholders. The Wisconsin resident shareholders must report their shares, based on stock ownership, of the corporation's entire income, loss, and deductions, regardless of the source.

However, for purposes of the recycling surcharge, a multistate corporation must determine its net income attributable to Wisconsin even if all of its shareholders are Wisconsin residents.

H. Computing Wisconsin Income of Nonresident Shareholders of Multistate Corporations

A tax-option (S) corporation deriving income in and outside Wisconsin and having any nonresident shareholders for any part of the taxable year must determine its income, loss, and deductions allocable to Wisconsin. All tax-option items are passed through to the shareholders on a daily basis, unless one or more of the rules for splitting the taxable year into separate periods is applicable. See Part IX.A.

A unitary, multistate corporation, determines its apportionment percentage on Form 4B or Form 4B-1, if appropriate, and shows the Wisconsin source amount on Wisconsin Schedule 5K-1, column e, for each of its part-year resident or nonresident shareholders. A non-unitary, multistate corporation must complete a

schedule similar to Form 4C to show the amounts allocable to Wisconsin before filling in Schedule 5K-1 for each of its part-year resident or nonresident shareholders.

Example: A nonresident held 40% of a corporation's capital stock from January 1 to September 30, 2005. On September 30, 2005, the shareholder sold the stock to a Wisconsin resident. The corporation's ordinary income for the calendar year 2005 is \$20,000. At the end of the year the corporation determines under the apportionment method that 65% of the year's income is derived in Wisconsin. Assuming that none of the year-splitting rules are applicable, the nonresident shareholder must report \$3,889 of the ordinary income to Wisconsin, which is computed as follows: $65\% \times 40\% \times 273/365 \times \$20,000 = \$3,889$. The nonresident shareholder's Schedule 5K-1 will show \$5,984 as the federal amount in column b, \$(0) as the adjustment in column c, \$5,984 as the amount under Wisconsin law in column d, and \$3,889 as the Wisconsin source amount in column e.

VIII. WHEN SHAREHOLDERS MUST REPORT CORPORATE INCOME (LOSS)

For Wisconsin purposes, the shareholder's share of corporate income, loss, and deductions is considered to be received throughout the corporation's taxable year, just as it is under the provisions of the Internal Revenue Code. Taxable distributions received from the corporation are taxable as of the day of receipt, although their treatment may not be determined until year-end.

A. Reporting Income (Loss) on the Shareholders' Income Tax Returns

Each shareholder, whether a resident or nonresident of Wisconsin, must report his or her share of a tax-option (S) corporation's income, loss, and deductions in his or her taxable year in which or with which the taxable year of the corporation ends, or in the final taxable year if the shareholder dies before the end of the corporation's taxable year.

Example 1: John Smith files his Wisconsin income tax returns on a calendar-year basis. He is one of two equal shareholders of a tax-option (S) corporation whose taxable year ends on July 31, 2005. The corporation's ordinary income for Wisconsin purposes for the July 31, 2005, year is \$5,000. John will include his

one-half share (\$2,500) of such income in his Wisconsin adjusted gross income for the 2005 calendar year.

Example 2: Assume the same facts as in Example 1, except that the corporation's taxable year ends on January 31, 2006. John will include \$2,500 in his 2006 calendar-year Wisconsin income.

Example 3: Mary Brown, a calendar-year taxpayer, is one of three equal shareholders of a calendar-year tax-option (S) corporation on January 1, 2005. She dies on July 31, 2005. The corporation's ordinary income for Wisconsin purposes for the 2005 calendar year is \$6,000. Assuming the corporation doesn't elect to split the year, Mary's personal representative will include \$1,162 ($212/365 \times \$2,000$) of such income on her final return and \$838 on her estate's income tax return for the year including December 31, 2005, assuming the estate held all of her stock for the intervening period.

B. Making Estimated Tax Payments

For the purpose of making estimated tax payments, tax-option (S) corporation income is considered to be received by shareholders as follows:

1. Tax-option (S) corporation income, loss, and deductions: throughout the corporation's taxable year.
2. Taxable distributions from the corporation: on the day of receipt.

If a corporation makes a distribution before the end of its taxable year, it may not be possible to determine on the day of receipt whether it is solely a nontaxable distribution of prior or current year net income or whether it is partially a taxable distribution. If, at the end of the corporation's taxable year, part or all of the distribution is determined to be taxable, it is considered taxable on the day of receipt. However, for the purpose of making estimated tax payments, income from a distribution is considered to be received on the last day of the corporation's taxable year if the taxability of the distribution can't be determined before the end of the corporation's taxable year.

If the tax-option (S) corporation is required to withhold income tax on the income allocable to a nonresident shareholder, the shareholder is not required to make estimated tax payments on his,

her, or its share of the corporation's income. If a nonresident shareholder has other sources of Wisconsin income, the nonresident may be required to make estimated payments based on that income.

IX. SHAREHOLDERS' WISCONSIN INCOME TAX RETURNS

The Wisconsin income of individuals, estates, and trusts is based upon their federal adjusted gross income. This federal income is then increased or decreased for specific items (called "modifications") which are treated differently on the Wisconsin return than federally.

For taxable years before 1979, all Subchapter S income or loss included in a person's federal adjusted gross income was eliminated through a modification on the person's Wisconsin return. Only actual dividends received were included in Wisconsin income. The elimination of Subchapter S income or loss and the inclusion of dividend income were required "modifications" under the Wisconsin Statutes then in effect.

Effective with the 1979 taxable year, the statutes requiring these modifications were repealed. Therefore, tax-option (S) corporation income, loss, and deductions, adjusted for Wisconsin purposes, must be reflected in a shareholder's Wisconsin taxable income for 1979 and thereafter.

Exception: If a corporation which is a federal S corporation elects not to be a Wisconsin tax-option corporation for 1987 or subsequent taxable years, modifications similar to those required for taxable years before 1979 are used to eliminate all items of S income or loss and to include the amount of any taxable distributions.

The tax-option (S) corporation must give a copy of Wisconsin Schedule 5K-1 to each shareholder showing the items of income, loss, and deduction to be reported on the shareholder's Wisconsin income tax return, including any applicable individual transitional adjustments or modifications, as described below. In addition, the corporation must give each shareholder a copy of the "Shareholder's Instructions for 2005 Schedule 5K-1."

A. Corporate Income Reportable by Shareholders

Each shareholder must report his, her, or its share of each item of tax-option (S) corporation income, loss, and deduction. Generally, the shareholder's share of each tax-option item is figured on a per day, per share basis. If there is no change in the percentage of stock

each shareholder owns during the corporation's taxable year, each shareholder's share of tax-option items is the amount of the item times the shareholder's percentage of stock ownership for the taxable year.

If a shareholder's interest in a tax-option (S) corporation is terminated during the taxable year, the corporation, with the concurrence of all affected shareholders, may elect, under IRC section 1377(a)(2), to allocate all tax-option items as if the corporation's taxable year consisted of two taxable years, the first of which ends on the date of the shareholder's termination. A similar election is available in the event of certain other qualifying dispositions described in section 1.1368-1(g)(2) of the federal Treasury Regulations. Such treatment may also be elected, and in some cases is required, if the tax-option (S) election is terminated in mid-year under IRC sections 1362(e)(2), (3), and (6)(D). To make these elections, the corporation must file a statement of election with its return for the taxable year of election and state that all affected shareholders have consented to the election. If making the election, indicate that one or more of these elections applies at the top of each Schedule 5K-1.

B. Individual Transitional Adjustments

The distribution in 1979 and thereafter of a corporation's earnings and profits accumulated as of the end of its 1978 taxable year may or may not be included in its shareholders' federal income, depending upon whether or not the earnings and profits were taxed federally to the shareholders in years before 1979. *However, all dividends received by Wisconsin resident shareholders from pre-1979 earnings and profits are subject to the Wisconsin tax. Therefore, a transitional adjustment is required for distributions from pre-1979 federal "undistributed" and "previously taxed" income which are not included in federal income when received by a resident shareholder.*

Example: In 2005, \$1,000 of pre-1979 earnings and profits is distributed to a resident shareholder. For federal income tax purposes, this amount is a nontaxable distribution of "previously taxed income." Therefore, the shareholder won't include the \$1,000 in 2005 federal income. For Wisconsin, the shareholder must add \$1,000 to 2005 federal adjusted gross income as a transitional adjustment on Form 1.

C. Modifications

The tax-option (S) corporation must compute its items of income, loss, and deduction for Wisconsin purposes as prescribed by the Wisconsin Statutes. If Wisconsin and federal tax-option items differ, modifications are required so that Wisconsin corporate income is taxed to, and losses are deducted by, shareholders at least once, but not more than once. Modifications that may be necessary in given situations are explained in the following sections.

1. Differences Between Federal and Wisconsin Tax-Option (S) Items

Generally, items of income, loss, and deduction are computed under the Internal Revenue Code in effect for Wisconsin purposes. The character of individual items of income and expense passes through to the shareholders. However, intangible income attributable to Wisconsin, except interest on United States government obligations, bonds issued by the government of Puerto Rico, and certain state and local government bonds, retains its character as business income and is taxable to nonresident shareholders. As explained in Part VII.C.2, additions to or subtractions from the federal amount of tax-option items may be necessary to determine the amounts reportable under Wisconsin law. Indicate a shareholder's share of such modifications on the shareholder's Wisconsin Schedule 5K-1.

2. Federal Itemized Deductions

For Wisconsin purposes, shareholders of a tax-option (S) corporation may treat tax-option items that are deductible federally as itemized deductions in either of the following ways:

- a. As deductions that may be includable in the Wisconsin itemized deduction credit. Include the amount that is deductible as a federal itemized deduction in the itemized deduction credit to the extent permitted under Wisconsin law.
- b. As modifications that are subtracted from federal adjusted gross income to arrive at Wisconsin adjusted gross income. Treat the amount that is deductible federally as a subtraction modification. However, for a nonresident or part-year resident shareholder

of a multistate corporation, the subtraction is further limited to that portion of the federal itemized deduction attributable to Wisconsin using apportionment or separate accounting, as appropriate.

Example 1: A multistate tax-option (S) corporation, whose sole shareholder is a Wisconsin resident, paid \$15,000 of investment interest expense and made \$2,000 of charitable contributions in 2005. These amounts pass through to the shareholder and are deductible on her federal Schedule A as itemized deductions. The shareholder determines that, due to the federal limitations on the deductibility of investment interest, only \$10,000 of the investment interest expense is deductible on federal Schedule A. She may deduct the entire \$2,000 of charitable contributions because her total contributions don't exceed the federal limits.

For Wisconsin purposes, the shareholder may either (a) use these deductions in computing her Wisconsin itemized deduction credit or (b) subtract them as modifications to arrive at her Wisconsin adjusted gross income.

If the shareholder includes these deductions in her itemized deduction credit, she may claim \$10,000 of the investment interest expense and the \$2,000 of charitable contributions (the amounts deductible federally). Alternatively, the shareholder may take \$10,000 of the investment interest expense and the \$2,000 of charitable contributions as subtraction modifications in computing her Wisconsin adjusted gross income.

Example 2: Assume the same facts as in Example 1, except that the tax-option (S) corporation's sole shareholder is a nonresident of Wisconsin. The corporation's Wisconsin apportionment percentage is 30%.

If the shareholder chooses to use these expenses in computing her Wisconsin itemized deduction credit, she may include \$10,000 of investment interest expense and \$2,000 of charitable contributions. (Note that a nonresident of Wisconsin must prorate the itemized deduction credit based on the ratio of Wisconsin adjusted gross income to federal adjusted gross income.)

If the shareholder chooses to treat these items as subtraction modifications, she may subtract the following amounts: investment interest expense of \$3,000 ($30\% \times \$10,000$) and charitable contributions of \$600 ($30\% \times \$2,000$). In this case, her subtraction modifications are limited to that portion of the deductions attributable to Wisconsin using the corporation's apportionment percentage.

Example 3: In 2005, a tax-option (S) corporation incurs \$1,000 of expenses in the production of investment income. For federal purposes, the corporation's sole shareholder may take these separately stated expenses as miscellaneous itemized deductions, subject to the 2% limit on such deductions. The shareholder determines that his miscellaneous itemized deductions don't exceed 2% of his federal adjusted gross income. Therefore, he can't actually deduct any portion of the \$1,000 of expenses passed through from the corporation.

For Wisconsin purposes, the shareholder cannot claim any portion of the \$1,000 either in the Wisconsin itemized deduction credit or as a subtraction modification.

Example 4: A tax-option (S) corporation has two Wisconsin resident shareholders, and each owns 50% of the corporation's stock. In 2005, the corporation pays \$800 per month, for a total of \$9,600, of health insurance premiums on behalf of Shareholder A, who is actively involved in the management of the business, and nothing for Shareholder B, who is merely a passive investor. Shareholders A and B are "2% shareholders," which are shareholders who own more than 2% of the corporation's stock.

For federal and Wisconsin purposes, qualifying health insurance costs paid on behalf of the 2% shareholder-employees are deductible in computing the corporation's net income. Therefore, one-half of the \$9,600 expense, or \$4,800, is allocated to each shareholder. The shareholders share the expense equally since the health insurance premiums paid on behalf of the 2% shareholders are treated in the same manner as any other deductible expense of the corporation.

In addition, the \$9,600 is taxable income to Shareholder A for both federal and Wisconsin purposes. Under federal law, certain fringe bene-

fits aren't eligible to be excluded from income for 2% shareholders. One of these benefits is the exemption under IRC section 106 for contributions by an employer to an accident or health plan. Therefore, 2% shareholder-employees must report the health insurance premiums paid by the corporation on their behalf as taxable income for federal and Wisconsin purposes.

Finally, for federal and Wisconsin income tax purposes, Shareholder A may deduct 100% of the health insurance premiums paid on his behalf as an adjustment to federal adjusted gross income as provided in IRC section 162(l).

3. Corporate Distributions

In general, Wisconsin resident shareholders must include all distributions received from a tax-option (S) corporation, other than from net income already taxed to the shareholders, in their Wisconsin adjusted gross incomes in the year of receipt. Dividend distributions received by non-resident shareholders aren't taxable by Wisconsin.

Past and current differences in the computation of a tax-option (S) corporation's federal and Wisconsin income, losses, and deductions, may create a difference between the federal and Wisconsin treatment of corporate distributions. See Part X.

4. Gain or Loss on Disposition of Capital Stock

When a Wisconsin resident shareholder disposes of capital stock in a tax-option (S) corporation in a taxable transaction, the shareholder must include the gain or loss on such disposition in Wisconsin adjusted gross income for the taxable year in which the stock is sold, exchanged, or becomes worthless, unless the installment sale or other rules serve to defer recognition of gain or loss. Since gain or loss on such disposition follows the residence of the shareholder, a nonresident shareholder doesn't include the gain or loss in his or her Wisconsin adjusted gross income.

If a resident shareholder's Wisconsin basis of the stock is the same as the federal basis, the Wisconsin gain or loss on disposition will be identical to the federal amount. If the Wisconsin and federal bases differ, a modification must be made to federal adjusted gross income for the difference.

A difference in basis may exist at the end of the corporation's 1978 taxable year if the corporation had reported under Subchapter S for federal tax purposes before the 1979 taxable year, the first year to which the Wisconsin tax-option (S) law applied. A Subchapter S corporation's pre-1979 federal undistributed taxable income, nontaxable distributions, and tax losses affect a shareholder's federal basis of the corporation's stock but not the Wisconsin basis.

Beginning with the 1979 taxable year, a Wisconsin resident shareholder's Wisconsin basis of a tax-option (S) corporation's capital stock is affected by 1979 and later years' Wisconsin corporate income and losses passed through and taxed to or deducted by shareholders for Wisconsin tax purposes. See Part XI for a description of how the Wisconsin basis of a shareholder's capital stock is computed.

Examples of the federal and Wisconsin gain or loss on the disposition of capital stock by shareholders of corporations which elected Subchapter S treatment for taxable years before 1979 follow.

Example 1: A corporation was incorporated on January 1, 1978. The corporation's two shareholders each invested \$7,000 in exchange for equal shares of its capital stock. The corporation elected to be taxed under federal Subchapter S beginning with its 1978 calendar year. Its 1978 federal taxable income was \$10,000, of which \$6,000 was distributed to its shareholders in cash on March 15, 1979. No further distributions of 1978 income were made.

The shareholders, who are Wisconsin residents, also file Wisconsin returns on a calendar-year basis. The shareholders' federal stock bases were increased by \$5,000, their shares of the 1978 income, and decreased by the \$3,000 distributions of 1978 income. Their Wisconsin stock bases were not affected by the 1978 income and cash distributions.

Assume that the corporation's Wisconsin net income equaled its federal net income for each of the years 1979 through 2004, and the entire amount of income was distributed to the shareholders each year. Thus for both federal and Wisconsin purposes, the increases in the shareholders' stock bases for their shares of the

corporation's net income were offset by the decreases for the cash distributions.

On August 31, 2005, Shareholder A sells all of his stock for \$20,000. For 2005, the corporation has \$15,000 of income. Assuming no year-splitting rule is applicable for the year of disposition, Shareholder A's share of the 2005 income is \$4,993 ($50\% \times 243/365 \times \$15,000$), which increases his stock basis by \$4,993. Shareholder A computes his federal and Wisconsin gain on the sale as follows:

	Federal	Wisconsin
Selling price	\$20,000	\$20,000
Basis on August 31, 2005	<u>13,993</u>	<u>11,993</u>
Gain on disposition	<u>\$ 6,007</u>	<u>\$ 8,007</u>

Example 2: Assume the same facts as in Example 1, except that the corporation had a \$10,000 federal tax loss for its 1978 taxable year and didn't distribute \$6,000 on March 15, 1979. The shareholders each deducted \$5,000 of the loss on their 1978 federal returns.

If Shareholder A sells his stock for \$20,000 on August 31, 2005, his federal gain is \$13,007 (\$20,000 minus \$6,993 basis); whereas his Wisconsin gain is still \$8,007 (\$20,000 minus \$11,993 basis).

However, if the stock is sold for \$5,000 on August 31, 2005, a federal loss of \$1,993 results (\$5,000 minus \$6,993 basis), and the Wisconsin loss is \$6,993 (\$5,000 minus \$11,993 basis).

D. Corporate Losses Deductible by Shareholders

A tax-option (S) corporation's losses for a year are passed through to all shareholders in the same manner as income during the year if the corporation is engaged in activities for the purpose of making a profit. Each person who is a shareholder at any time during the corporation's taxable year may deduct a pro rata share of such losses. However, the amount of loss that may be deducted each year is subject to certain limits.

1. Basis Limit

The amount of loss and deductions that a shareholder may take is limited to the shareholder's

Wisconsin basis in capital stock and indebtedness of the corporation as of the end of the corporation's taxable year, as described in Part XI. If stock is disposed of during the year, figure its basis and figure the basis of indebtedness as of the close of the last day the person was a shareholder.

If a shareholder's pro rata share of corporate losses and deductions exceeds the shareholder's Wisconsin basis in stock and indebtedness, any disallowed loss may be carried over indefinitely. The loss may be used whenever the shareholder has sufficient basis to apply against the amount carried over in a year in which the corporation is a tax-option corporation, or during the post-termination transition period, in a manner similar to the federal rules.

If in any subsequent year there is a positive basis adjustment, this increase will be applied first to restore the basis in indebtedness to the extent of any prior reduction for any taxable year beginning after December 31, 1982, before the shareholder's stock basis can be increased.

If a shareholder's allowable deduction for his, her, or its pro rata share of the corporation's losses results in a loss on the shareholder's Wisconsin income tax return, the loss generally is treated in the same manner as other Wisconsin net operating losses. However, unlike other Wisconsin net operating losses, Wisconsin tax-option (S) corporation losses may be claimed even if the shareholder has no federal net operating loss. For losses incurred in the 1980 taxable year and thereafter, a Wisconsin net operating loss may be carried forward against Wisconsin taxable income for 15 years.

Example 1: On January 1, 2004, a shareholder invested \$7,000 to acquire 50% of a tax-option (S) corporation's capital stock. The shareholder and corporation each file returns on a calendar-year basis and the corporation has no indebtedness owing to the shareholder. For the 2004 calendar year, the corporation computed a \$10,000 ordinary loss on its Wisconsin franchise or income tax return. The corporation didn't make any distributions to the shareholder. The shareholder deducted \$5,000 (50% of the \$10,000 loss) on her 2004 Wisconsin return.

For the 2005 calendar year, the corporation computes a \$12,000 ordinary loss and doesn't make any distributions. The shareholder's share of the loss is \$6,000. However, the shareholder may deduct only \$2,000 on her 2005 Wisconsin return, since her basis in the corporation's capital stock on December 31, 2005, is \$2,000 (\$7,000 original investment minus \$5,000 2004 ordinary loss passed through). For this purpose, she computes her basis on December 31, 2005, without reduction for the current (2005) year's operating loss. The shareholder may carry over the remaining \$4,000 of her portion of the 2005 loss and deduct it on her returns for future tax-option (or post-termination transition period) years, whenever she has basis to apply against the loss.

Example 2: A tax-option (S) corporation and its sole shareholder file returns on a calendar-year basis. The shareholder organized the corporation on January 1, 2004, with an investment of \$5,000 in capital stock and a \$5,000 loan to the corporation, represented by an interest-bearing note. The corporation elected to be taxed under Subchapter S for federal purposes effective for its taxable year ending December 31, 2004. The corporation incurs ordinary losses for Wisconsin purposes of \$6,000 and \$8,000 for its taxable years ended December 31, 2004, and December 31, 2005, respectively. Interest on the note is paid when due, but no part of the loan principal is repaid by December 31, 2005. In addition, the corporation doesn't make any property distributions.

For Wisconsin purposes the sole shareholder deducted the \$6,000 ordinary loss for the year ended December 31, 2004, on his 2004 calendar-year return. On the shareholder's 2005 Wisconsin return, he may deduct only \$4,000 of the corporation's \$8,000 ordinary loss for its taxable year ended December 31, 2005. This amount is equal to the shareholder's remaining Wisconsin basis in stock and indebtedness, computed as follows: \$5,000 stock investment plus \$5,000 loan minus \$6,000 ordinary loss for the taxable year ended December 31, 2004. The shareholder may carry over the remaining portion of the latter year's loss (\$4,000) to future years for Wisconsin purposes.

Note: The losses deducted by the shareholder first reduce the basis of his stock in the corporation, then the basis of the loan. In this example, the

shareholder computes the Wisconsin basis of the stock and loan as follows:

	Stock	Loan
Original investment	\$ 5,000	\$ 5,000
Dec. 31, 2004, loss deducted	(5,000)	(1,000)
Dec. 31, 2005, loss deducted	<u>-0-</u>	<u>(4,000)</u>
Basis on January 1, 2006	<u>\$ -0-</u>	<u>\$ -0-</u>

If the loan is repaid in full on January 1, 2006, and the corporation has no taxable income for the year ended December 31, 2006, the shareholder will realize \$5,000 of taxable income for Wisconsin purposes. Since the loan was evidenced by a note that was outstanding for more than one year, the \$5,000 is capital gain income. If, in the alternative, the loan had not been evidenced by a note, all the income upon repayment would be ordinary income.

Example 3: Assume the same facts as in Example 2, except that the corporation doesn't repay the loan on January 1, 2006, it earns \$9,000 of ordinary income for the year ended December 31, 2006, and it doesn't make any distributions. The \$4,000 suspended loss is treated as incurred in the current year, resulting in net ordinary income of \$5,000. The basis of the shareholder's loan will be restored to \$5,000. The shareholder's stock basis will remain at zero.

Example 4: On January 1, 2004, a nonresident of Wisconsin invested \$10,000 to acquire 100% of a tax-option (S) corporation's capital stock. The shareholder and the corporation each file returns on a calendar-year basis and the corporation has no indebtedness owing to the shareholder. The corporation does business in and outside Wisconsin. For the 2004 calendar year, the corporation computed a \$10,000 ordinary loss, of which 40% was attributable to Wisconsin. Since the shareholder is a nonresident, she may deduct \$4,000 of the loss (40% x \$10,000) on her 2004 Wisconsin return. The shareholder's Wisconsin stock basis is decreased to zero by the \$10,000 loss as determined under Wisconsin law.

In 2005, the corporation computes a \$15,000 ordinary loss, of which 55% is attributable to Wisconsin. The shareholder may not deduct any part of the \$8,250 loss attributable to Wisconsin on her 2005 Wisconsin return. She may carry over the 2005 Wisconsin loss and deduct it on her re-

turns for future tax-option (or post-termination transition period) years, whenever she has Wisconsin basis to apply against the loss.

Note: A shareholder's Wisconsin basis in stock of a multistate corporation is reduced by his or her pro rata share of the total company loss as determined under Wisconsin law. This is the shareholder's loss *before* application of either apportionment or separate accounting to arrive at the amount attributable to Wisconsin operations.

2. At-Risk Limit

The federal at-risk rules may limit a shareholder's deductible loss from an activity conducted through a tax-option (S) corporation. These rules also apply for Wisconsin purposes, and apply after the basis limits.

The at-risk rules generally apply to a shareholder who has —

- A loss or other deduction from any activity carried on by the corporation as a trade or business or for the production of income, and
- Amounts in the activity for which the shareholder isn't at risk.

A shareholder's amount at risk generally includes —

- The shareholder's cash contributions and the adjusted basis of other property that the shareholder contributed to the tax-option (S) corporation, plus
- Amounts borrowed for use in the activity that the shareholder is personally liable for the repayment of, or has pledged property not used in the activity as security for the borrowed amount.

The at-risk limitations apply at the shareholder level. To determine if the at-risk rules apply to an activity, the tax-option (S) corporation must identify each activity in which it is engaged and provide each shareholder with a schedule reflecting that shareholder's share of the gross income and deductions for each activity.

3. Passive Activity Limit

Internal Revenue Code section 469 provides rules that limit the deduction of certain losses. Although these limits don't apply to a tax-option (S) corporation directly, they may apply to its shareholders. The passive activity loss limits apply after the at-risk limits.

Generally, a passive activity is any activity that involves the conduct of any trade or business in which the shareholder doesn't materially participate and rental activities, as defined in the federal regulations. Rental real estate activities in which a shareholder materially participates are not passive activities if the shareholder meets certain eligibility requirements. The corporation must identify separately each activity that may be passive to a shareholder.

The passive activity rules also apply for Wisconsin purposes. However, if a shareholder's federal and Wisconsin income from the corporation differs, the shareholder may have to recompute the amount of passive activity loss deductible for Wisconsin, depending on the reason for the difference.

There are three types of differences between federal and Wisconsin income:

- Schedule I adjustments required in computing federal adjusted gross income for Wisconsin purposes because a provision of the Internal Revenue Code doesn't apply for Wisconsin or a federal law change becomes effective at a different time than federally. For example, adjustments required because Wisconsin has not adopted the federal increase in the section 179 deduction from \$25,000 to \$100,000, with inflation adjustments, the federal 30% or 50% bonus depreciation, or the federal exclusion for extraterritorial income are Schedule I adjustments.
- Adjustments required because different elections are made when calculating federal adjusted gross income for federal and Wisconsin purposes. For example, if the federal work opportunity tax credit is claimed instead of a federal deduction for the wages, the entire amount of wages paid may be deducted for Wisconsin purposes.

- Modifications to federal adjusted gross income required under sec. 71.05(6) to (12), (19), and (20), Wis. Stats. Modifications include the addition to federal adjusted gross income of state and local government bond interest income and the subtraction of the 60% capital gain deduction.

The passive activity loss limits must be recomputed for differences between federal and Wisconsin income resulting from Schedule I adjustments or making different elections. However, the loss limits aren't recomputed for modifications.

Example 1: A shareholder must treat her interest in a tax-option (S) corporation as a passive activity. In 2004, the corporation had placed in service property located in Wisconsin. For federal purposes, the corporation claimed 50% bonus depreciation. However, for Wisconsin purposes, the corporation was required to compute depreciation on the property under the Internal Revenue Code as amended to December 31, 2000. As a result of the differing depreciation deductions, the shareholder's rental loss differs for federal and Wisconsin purposes. The shareholder must recompute her allowable passive activity losses for Wisconsin.

Example 2: A shareholder must treat his interest in a tax-option (S) corporation as a passive activity. For federal purposes, the corporation elected to claim the work opportunity tax credit instead of a deduction for the portion of the wages equal to the credit. For Wisconsin purposes, the corporation deducts the wages paid or incurred that weren't deductible federally. The shareholder must recompute his allowable passive activity losses for Wisconsin.

Example 3: A shareholder must treat his interest in a tax-option (S) corporation as a passive activity. The corporation sold property that had been used in its trade or business for more than one year and realized a gain, which is treated as a long-term capital gain. For Wisconsin purposes, the capital gain qualifies for Wisconsin's 60% capital gain deduction. The shareholder is not required to recompute his allowable passive activity losses for Wisconsin.

Example 4: A shareholder must treat her interest in a federal S corporation as a passive activity. For Wisconsin purposes, the corporation elects not to be a tax-option corporation. To figure her Wisconsin income, the shareholder subtracts her share of the corporation's undistributed net income that she had included in her federal adjusted gross income. The shareholder may not recompute her allowable passive activity losses for Wisconsin by excluding the S corporation income.

Example 5: A shareholder, who is a nonresident of Wisconsin, must treat his interest in a tax-option corporation as a passive activity. The corporation does business in and outside Wisconsin. The shareholder is subject to Wisconsin income tax on income derived from property located, business transacted, and services performed in Wisconsin. The shareholder's Wisconsin passive activity loss is limited to the amount that was allowed for federal purposes. He may not recompute the allowable passive activity loss by excluding the income and losses that are not taxable by or deductible for Wisconsin purposes.

E. Credits Available for Shareholders

1. Manufacturer's Sales Tax Credit

The shareholders of a tax-option (S) corporation may claim credit for their pro rata shares of the corporation's manufacturer's sales tax credit computed for taxable years beginning on or after January 1, 1998. The credit is based on the amount of Wisconsin state, county, and baseball and football stadium sales and use taxes paid on fuel and electricity consumed in manufacturing tangible personal property in Wisconsin. The corporation computes the credit on Wisconsin Schedule Z and Schedule Z-1, if applicable. The corporation has the option of claiming the credit against its own franchise tax liability or passing all or part of the credit through to its shareholders.

The manufacturer's sales tax credit is a nonrefundable credit, limited to that portion of a shareholder's net tax that is imposed on or measured by the Wisconsin net income of the tax-option (S) corporation. If a shareholder has a net loss from the tax-option (S) corporation, no manufacturer's sales tax credit may be claimed. Shareholders claim their pro rata shares of the

credit by filing Wisconsin Schedule MS and their Schedules 5K-1 with their Wisconsin income tax returns.

Unused credits computed for taxable years beginning on or after January 1, 1998, may be carried forward for 20 years and applied against the corporation's franchise tax liability or the shareholders' income tax measured by the net income of the tax-option (S) corporation.

Manufacturer's sales tax credits that a tax-option (S) corporation computed beginning with its 1987 taxable year through taxable years beginning before January 1, 1998, may not be passed through to the shareholders.

Note: Beginning January 1, 2006, sales of fuel and electricity consumed in manufacturing tangible personal property are exempt from sales and use tax. The 2006 treatment of any unused manufacturer's sales tax credit will depend on whether the unused credit is \$25,000 or less or more than \$25,000.

2. Dairy Investment Credit

For taxable years beginning on or after January 1, 2004, and before January 1, 2010, the shareholders of a tax-option (S) corporation may claim credit for their pro rata shares of the corporation's dairy investment credit. The credit is based on certain amounts paid for dairy farm modernization or expansion of the corporation's dairy farm in Wisconsin. The corporation computes the credit on Wisconsin Schedule DI. The maximum credit that may be computed by the corporation during the 6-year period is \$50,000.

The dairy investment credit is a nonrefundable credit. Shareholders claim their pro rata shares of the credit by filing Wisconsin Schedule DI and their Schedules 5K-1 with their Wisconsin income tax returns. Unused credits may be carried forward for 15 years.

3. Development Zones Credits

The shareholders of a tax-option (S) corporation may claim credits for their pro rata shares of the corporation's credits for doing business in Wisconsin development, development opportunity, enterprise development, or agricultural develop-

ment zones. The development zones credits generally are based on the corporation's expenditures for environmental remediation and job creation or retention in the development zone.

The credits are computed at the corporate level on Wisconsin Schedule DC and then passed through to the shareholders. The shareholders claim their pro rata shares of the credits by filing their own Schedules DC and Schedules 5K-1 with their Wisconsin income tax returns.

The development zones credits are nonrefundable. Unused credits may be carried forward for 15 years.

4. Technology Zone Credit

For taxable years beginning on or after January 1, 2002, the shareholders of a tax-option (S) corporation may claim credit for their pro rata shares of the corporation's credit for doing business in a Wisconsin technology zone. The credit is a percentage, determined by the Department of Commerce, of the Wisconsin real and personal property taxes paid, 10% of the capital investments made, and 15% of the amount spent for the first 12 months of wages for each job created after certification of the corporation. The corporation computes the credit on Wisconsin Schedule TC and then passes it through to the shareholders. The shareholders claim their pro rata shares of the credit by filing their own Schedules TC and Schedules 5K-1 with their Wisconsin income tax returns. The technology zone credit is nonrefundable. Any unused credit may be carried forward for 15 years.

5. Supplement to Federal Historic Rehabilitation Tax Credit

The shareholders of a tax-option (S) corporation may claim credit for their pro rata shares of the corporation's credit for rehabilitating certified historic structures located in Wisconsin and used for business purposes. This credit is computed at the corporate level on Wisconsin Schedule HR and then passed through to the shareholders. The shareholders claim their pro rata shares of the credit by filing their own Schedules HR and Schedules 5K-1 with their Wisconsin income tax returns. The credit is nonrefundable. Any unused credit may be carried forward for 15 years.

6. Early Stage Seed Investment Credit

Shareholders of a tax-option (S) corporation that is making payments to a Department of Commerce qualified fund manager for investment in a qualified new business venture may be eligible for a tax credit. This credit is computed at the corporate level and then passed through to the shareholders. The shareholders claim their pro rata shares of the credit, or the amounts specially allocated to them in the corporation's organizational agreements, by filing their own Schedules VC and Schedules 5K-1 with their Wisconsin income tax returns. The credit is nonrefundable. Any unused credit may be carried forward for 15 years.

7. Farmland Preservation Credit

A Wisconsin resident shareholder of a tax-option (S) corporation that owns farmland located in Wisconsin may be able to claim credits based, in part, on his or her pro rata share of the corporation's property taxes. The farmland preservation credit is claimed by filing Wisconsin Schedule FC with the shareholder's Wisconsin income tax return.

8. Farmland Tax Relief Credit

Wisconsin resident shareholders of a tax-option (S) corporation that owns farmland located in Wisconsin may qualify for the farmland tax relief credit. For a shareholder's taxable year beginning in 2005, the credit is 20% of the shareholder's pro rata share of qualifying property taxes levied during 2005 on the corporation's Wisconsin farmland, up to a maximum credit of \$1,500. For more information, see the Wisconsin Form 1 or 1NPR instructions.

9. Credit for Taxes Paid to Other States by Wisconsin Resident Shareholders

If a tax-option (S) corporation does business in another state and either the corporation or its shareholders must pay an income or franchise tax on or measured by the corporation's income earned there, the Wisconsin resident shareholders may be able to claim credit on their individual income tax returns for their pro rata shares of the tax paid. To qualify for the credit, the income taxed by the other state must also be considered

taxable income by Wisconsin. The shareholders claim their pro rata shares of the credit by filing their own Wisconsin Schedule OS with their Wisconsin income tax returns.

The shareholders must submit verification of the amount of their credits with their Wisconsin income tax returns as follows —

- a. If the corporation's S status is recognized by the other state and —
 - The Wisconsin resident shareholder files an individual income tax return with that state and pays tax on his or her pro rata share of the corporation's income earned there, the shareholder must submit a copy of the other state's tax return.
 - The corporation files a combined or composite return with that state on behalf of the shareholders who are nonresidents of that state and pays the tax on their pro rata shares of the corporation's income earned there, the Wisconsin resident shareholder must attach a copy of his or her Wisconsin Schedule 5K-1 to the Wisconsin return filed. The corporation must allocate the tax paid to the other state among such shareholders based on their pro rata shares of the income earned in that state and report each shareholder's share on Schedule 5K-1, line 13i. The corporation must attach a copy of the other state's tax return to the Form 5S it files with the Department of Revenue.
 - The corporation files a corporate franchise or income tax return with that state and pays tax on the income earned there that is attributable to the shareholders who are nonresidents of that state, the Wisconsin resident shareholder must attach a copy of his or her Wisconsin Schedule 5K-1 to the Wisconsin return filed. The corporation must allocate the tax paid to the other state among such shareholders based on their pro rata shares of the income earned in that state and report each shareholder's share on Schedule 5K-1, line 13i. The corporation must attach a copy of the other state's tax return to the Form 5S it files with the Department of Revenue.

Example: A Wisconsin tax-option (S) corporation does business in another state which recognizes its S status but taxes the corporation on the nonresident shareholders' shares of the corporation's income earned in that state. The corporation has five equal shareholders; three are Wisconsin residents and two are residents of the other state. For 2005, the corporation has \$50,000 of taxable income, of which \$35,000 is attributable to Wisconsin and \$15,000 is attributable to the other state. The corporation pays \$780 of tax to the other state on \$9,000 of income (the Wisconsin resident shareholders' 60% pro rata shares of the \$15,000 of income attributable to that state). One-third of the tax paid, or \$260, is allocated to each of the Wisconsin resident shareholders.

- b. If the corporation's S status isn't recognized by the other state and the corporation pays an income or franchise tax on or measured by the income earned there, the Wisconsin resident shareholder must attach a copy of his or her Wisconsin Schedule 5K-1 to the Wisconsin return filed. The corporation must allocate the tax paid to the other state among all the shareholders based on their pro rata shares of stock ownership and report each shareholder's share on Schedule 5K-1, line 13i. The corporation must attach a copy of the other state's tax return to the Form 5S it files with the Department of Revenue.

Example: A Wisconsin tax-option (S) corporation does business in another state which doesn't recognize its S status. The corporation has five equal shareholders; three are Wisconsin residents, one was a Wisconsin resident for three months of the corporation's 2005 calendar year, and one is a nonresident. For 2005, the corporation pays \$1,000 of tax to the other state. One-fifth of the tax paid, or \$200, is allocated to each of the Wisconsin resident shareholders. One-fourth of one-fifth of the tax paid, or \$50, is allocated to the part-year resident shareholder.

- c. If the corporation isn't subject to Wisconsin franchise or income tax law and the corporation pays an income or franchise tax to

another state on or measured by the income earned there, the Wisconsin resident shareholder must submit a letter from the corporation. The letter must include a schedule showing the shareholder's pro rata share of the items taxed by the state, the adjusted gross income, and the net tax paid.

State taxes that may qualify for the credit include the following:

- Illinois replacement tax.
- Michigan single business tax, provided the alternative gross receipts short method isn't used to compute the tax.
- New York tax based on net income.
- Pennsylvania net income tax.
- Texas franchise tax to the extent that it is based on net taxable earned surplus.

State taxes that **do not** qualify for the credit include the following:

- Michigan single business tax computed using the gross receipts short method.
- Minnesota built-in gains tax, capital gains tax, excess passive income tax, or minimum fee.
- New York fixed dollar minimum tax, tax imposed on subsidiary capital, or franchise tax based on allocated capital.
- Pennsylvania capital stock tax, franchise tax, or corporation loans tax.
- Washington business and occupation tax.
- Texas franchise tax to the extent based on net taxable capital.

For additional information, see the tax release in *Wisconsin Tax Bulletin* 85 (January 1994, page 21).

10. Withholding Tax Credit for Nonresident Shareholders

If a tax-option (S) corporation is subject to withholding tax on the income allocable to nonresident shareholders, those nonresident shareholders may claim credit on their individual or fiduciary income tax returns for their share of the tax paid. The nonresident shareholder must at-

tach a copy of his, her, or its Schedule 5K-1 to the Wisconsin income tax return filed.

F. Wisconsin Resident Shareholders of S Corporations That Aren't Required to File Wisconsin Franchise or Income Tax Returns

S corporations that aren't domiciled in Wisconsin or aren't authorized to transact business in Wisconsin and that aren't engaged in business in Wisconsin to the degree necessary to have a Wisconsin franchise or income tax filing requirement aren't subject to the Wisconsin tax-option (S) corporation law. However, Wisconsin resident shareholders of these corporations must report the same income or loss to Wisconsin as they report on their federal returns, adjusted for necessary transitional adjustments and certain modifications.

The transitional adjustments described in Part IX.B apply to Wisconsin resident shareholders of corporations not subject to the Wisconsin tax-option (S) corporation law. However, not all of the modifications described in Part IX.C apply.

The modifications described in Part IX.C.1 and 2 for a shareholder's share of the difference in a corporation's federal and Wisconsin items of income, loss, and deduction should not be made. The corporation isn't required to file a Wisconsin income or franchise tax return and, therefore, doesn't compute income or loss under the Wisconsin Statutes. Thus, the items of income, loss, and deduction are passed through to the shareholders and included on the shareholders' Wisconsin returns in the same manner as for federal purposes.

Since income, loss, and deductions flow through separately to the Wisconsin return, modifications may be necessary to conform to Wisconsin law concerning the income taxable and the deductions allowable to a Wisconsin resident. For example, an addition modification is required for municipal bond interest, and a credit, instead of a deduction, may be allowable for charitable contributions.

A Wisconsin resident shareholder of such a corporation must modify federal S corporation income or loss for the federal and Wisconsin stock and debt basis differences described in Part IX.C.3 and 4. However, the characterization of distributions as dividend or nondividend is determined under the federal rules because no Wisconsin AAA is computed for the corporation.

A Wisconsin resident shareholder of this type of corporation also is entitled to modify federal S corporation income or loss for the shareholder's share of a federal deduction which the corporation chooses not to take on its federal return, but the benefit for which is claimed as a tax credit on its shareholders' individual federal returns.

Example: A federal S corporation, which is organized under the laws of Michigan, isn't engaged in business in Wisconsin and isn't required to file a Wisconsin franchise or income tax return. The corporation has two equal shareholders, one a Wisconsin resident and one a Michigan resident, who file returns on a calendar-year basis. The corporation computes \$24,000 of ordinary income on its 2005 federal calendar-year return, but doesn't claim a deduction for \$10,000 of wages paid under the federal work opportunity tax credit program.

Each of the shareholders will include \$12,000 (one-half share of the corporation's 2005 federal ordinary income of \$24,000) in 2005 federal adjusted gross income and will reduce his 2005 federal tax liability for his pro rata share of the work opportunity tax credit. The Wisconsin resident shareholder may make a subtraction modification for \$5,000 (one-half share of the unclaimed \$10,000 deduction for wages) on his 2005 Wisconsin return, leaving net S corporation income of \$7,000 in Wisconsin taxable income.

If a federal S corporation has elected out of Wisconsin tax-option status, its Wisconsin resident shareholders must make modifications to their federal adjusted gross income and Wisconsin itemized deduction credit to exclude all items of S corporation income, loss, and deduction. In addition, these shareholders must add to their federal adjusted gross income the amount of any distributions received from the corporation, to the extent these distributions are made from retained earnings of the corporation. These shareholders aren't eligible for credit for state income taxes they paid to other states on the S corporation income.

G. Composite Return for Nonresident Shareholders

A tax-option (S) corporation that does business in Wisconsin and has **two or more** nonresident shareholders who derive no taxable income or deductible loss from Wisconsin other than their pro rata shares of the tax-option (S) corporation's Wisconsin income or loss may file a composite individual and fiduciary income tax return on behalf of those shareholders. The

tax-option (S) corporation files this return on Form 1CNS.

A shareholder may not participate in this composite return if —

- The shareholder is an estate or trust that has distributable income in the current year. This includes qualified Subchapter S trusts (QSSTs) and their beneficiaries.
- The shareholder files his or her individual or fiduciary income tax return on a fiscal year basis.
- The shareholder is a Wisconsin resident during any part of 2005.
- The shareholder derives taxable income from Wisconsin in 2005 other than his or her pro rata share of tax-option (S) corporation income or loss from one corporation.
- The shareholder wishes to claim any deductions or tax credits.

Each qualifying and participating shareholder's pro rata share of tax-option (S) corporation income or loss for a corporation's taxable year ending between January 31, 2005, and December 31, 2005, is reported on a 2005 Form 1CNS. The composite return replaces the separate 2005 Wisconsin individual or fiduciary income tax returns that otherwise would be filed by each of the qualifying and participating nonresident shareholders. The 2005 Form 1CNS is due April 17, 2006.

X. TAX TREATMENT OF DISTRIBUTIONS

A. Wisconsin Accumulated Adjustments Account

The **Wisconsin Accumulated Adjustments Account (AAA)** is an account of a tax-option (S) corporation that is used in taxable years beginning after December 31, 1982, to compute the Wisconsin tax effect of distributions from the corporation to its shareholders. The Wisconsin AAA will have a zero balance on the first day of the corporation's first taxable year as a tax-option (S) corporation beginning after December 31, 1982.

In the case of an existing non-Wisconsin S corporation that later begins doing business in Wisconsin, the Wisconsin AAA will have a zero balance on the first day of the first taxable year in which the corporation

becomes subject to Wisconsin's franchise or income tax jurisdiction.

1. Corporations Without Accumulated Earnings and Profits

At the end of the current taxable year, **if the corporation doesn't have accumulated earnings and profits for Wisconsin purposes**, the Wisconsin AAA is increased or decreased by the following items:

Increased by:

- Taxable income and gains, as determined under Wisconsin law.
- Nontaxable income earned in taxable year 1987 and thereafter (nontaxable income earned before 1987 didn't increase the Wisconsin AAA).

Decreased by:

- Deductible losses and expenses, as determined under Wisconsin law.
- Nondeductible expenses, not due to timing differences (that is, expenses that are never deductible for Wisconsin purposes).
- Property distributions, including cash, made by the corporation that are applicable to the Wisconsin AAA.
- The amount of the supplement to the federal historic rehabilitation tax credit computed.

2. Corporations With Accumulated Earnings and Profits

At the end of the current taxable year, **if the corporation has accumulated earnings and profits for Wisconsin purposes**, the Wisconsin AAA is increased or decreased by the following items in the order listed:

- a. Increased by taxable income and gains, as determined under Wisconsin law.

b. Decreased by:

- (1) Deductible losses and expenses, as determined under Wisconsin law, and expenses that are never deductible for Wisconsin purposes. However, if the total decreases exceed the total increases above, the excess is a “net negative adjustment” that is taken into account in (3) below.
- (2) Property distributions, including cash, other than dividend distributions from accumulated earnings and profits, unless the corporation elects to reduce accumulated earnings and profits first. **Note:** Distributions cannot reduce the Wisconsin AAA below zero.
- (3) Any net negative adjustment.
- (4) The supplement to the federal historic rehabilitation tax credit computed.

In this case, the Wisconsin AAA isn’t increased by nontaxable income nor decreased by nondeductible expenses related to nontaxable income. Instead, adjustments for nontaxable income and related expenses are made to the Wisconsin Other Adjustments Account as explained below. If the tax-option (S) corporation is subject to a Wisconsin franchise tax measured by certain federal, state, and municipal government bond interest, that interest is treated as taxable income which increases the Wisconsin AAA.

Note: For purposes of the Wisconsin AAA, taxable income and deductible losses and expenses are the total company amounts as determined under Wisconsin law. The total company amounts are those before application of either apportionment or separate accounting to compute a multistate corporation’s income, loss, and deductions attributable to Wisconsin.

As with the federal AAA, the Wisconsin AAA may have a negative balance. Due to past and current differences in the computation of income, loss, and deductions, the federal AAA and Wisconsin AAA may not have the same balance. This may create a difference between the federal and Wisconsin treatment of all or a part of any corporate distributions at the shareholder level.

B. Wisconsin Other Adjustments Account

The **Wisconsin Other Adjustments Account (OAA)** is maintained only by corporations that have accumulated earnings and profits at year-end. Since 1987 was the first year for which a Wisconsin OAA may be used, the Wisconsin OAA will have a zero balance at the beginning of the corporation’s 1987 taxable year. The account is increased by nontaxable income and decreased by related expenses. The account is also decreased by any distributions during the taxable year that are applicable to the Wisconsin OAA.

If a tax-option (S) corporation is subject to a franchise tax measured by certain federal, state, and municipal government bond interest, that interest is treated as taxable income which increases the Wisconsin AAA, not the Wisconsin OAA. However, interest income that is exempt from Wisconsin taxation, such as interest on bonds issued by the government of Puerto Rico, increases the Wisconsin OAA.

If a tax-option (S) corporation is the beneficiary of a life insurance contract payable by reason of the death of an officer of the corporation, the following treatment applies:

- The proceeds of the officer’s life insurance policy are nontaxable income of the corporation. The proceeds of life insurance policies paid to the beneficiary are generally excludable from gross income under IRC section 101.

If the corporation does not have accumulated earnings and profits, the corporation must add the officer’s life insurance proceeds to its Wisconsin AAA. If the corporation has accumulated earnings and profits, the corporation must add the officer’s life insurance proceeds to its Wisconsin OAA.

- The corporation may not add the increase in the cash surrender value of the officer’s life insurance policy to its Wisconsin AAA or OAA.
- Officer’s life insurance premiums paid by the corporation are nondeductible expenses. Premium payments are nondeductible under IRC section 264 and Treasury Regulation section 1.264-1(b). Since this expense is related to nontaxable income, report it in the same account where the nontaxable income would be reported. If the corporation does not have accumulated earnings and profits, this account is its Wisconsin AAA. If the corporation has accumulated earnings and profits, this account is its Wisconsin OAA.

The Wisconsin AAA and OAA are reconciled for the year on Form 5S, Schedule 5M. Due to differences in the computation of Wisconsin, federal, and book net income or loss, the Wisconsin AAA and OAA may not agree with either the federal AAA and OAA or book balance sheet retained earnings (on Form 1120S, Schedule L).

C. Distributions

For Wisconsin, property distributions, including cash, generally are treated as made from the following sources in the order shown:

1. A nontaxable distribution of net income to the extent of the Wisconsin AAA, but not in excess of the shareholder's Wisconsin stock basis. For distributions made in taxable years beginning on or after January 1, 1997, the Wisconsin AAA is determined without regard to any "net negative adjustment" for the taxable year.

A **net negative adjustment** is the excess, if any, of reductions in the AAA for the taxable year, other than for distributions, over the increases in the AAA for the taxable year.

2. A nontaxable distribution of the shareholder's Wisconsin "previously taxed undistributed income" from the 1979 taxable year through the last taxable year beginning before January 1, 1983, but not excess of the shareholder's Wisconsin stock basis after applying the distributions in 1 above.
3. A taxable dividend to the extent of Wisconsin accumulated earnings and profits.
4. A nontaxable distribution of exempt income to the extent of the Wisconsin OAA, but not in excess of the shareholder's Wisconsin stock basis after applying the distributions in 1 and 2 above.
5. A nontaxable return of capital to the extent of the shareholder's Wisconsin stock basis after applying the distributions in 1, 2, and 4 above.

All nondividend distributions in excess of basis are treated as taxable gain from the sale or exchange of property. Dividends are taxable as ordinary income.

If a tax-option (S) corporation makes more than one distribution to its shareholders during its taxable year

and the total distribution exceeds the amount in the Wisconsin AAA at the end of the corporation's taxable year determined without regard to any net negative adjustment for the taxable year, allocate the amount in the Wisconsin AAA among the distributions on a proportionate basis.

The tax-option (S) corporation may elect, with the consent of its affected shareholders, to modify the ordering rules for distributions as follows:

- To distribute accumulated earnings and profits before making distributions from the Wisconsin AAA.
- To make a deemed dividend.
- To forgo distributions of previously taxed income.

If a Subchapter S election is revoked or terminated, distributions of money during the post-termination transition period by the former tax-option (S) corporation to its shareholders are nontaxable to the extent of the corporation's Wisconsin AAA, but not in excess of a shareholder's stock basis. These nontaxable distributions reduce the adjusted basis of the shareholder's stock.

Alternatively, the corporation may elect, with the consent of its affected shareholders, to have distributions of money treated as dividends not made from the AAA to the extent of the corporation's accumulated earnings and profits for Wisconsin purposes.

The making of any of the foregoing elections by the corporation, or its failure to do so, for federal purposes shall be deemed to be applicable for purposes of making the corresponding determinations with respect to the treatment of distributions under Wisconsin law, unless the corporation affirmatively makes different elections for Wisconsin tax purposes.

Example 1: A calendar-year corporation with accumulated earnings and profits at the end of 2004 elects to be an S corporation for 2005 and that election applies for Wisconsin purposes. In 2005, it has federal nonseparately stated income of \$30,000, including a \$70 deduction for the recycling surcharge, and municipal bond interest of \$5,000. The corporation's two shareholders each have a Wisconsin stock basis of \$4,000 on January 1, 2005. The corporation distributes \$35,000 on December 31, 2005.

Each shareholder will include \$17,535 of tax-option (S) corporation income in 2005 Wisconsin income (\$15,000 of nonseparately stated income for federal tax purposes plus \$35 of nondeductible recycling surcharge and \$2,500 of separately stated municipal bond interest, which are reported as addition modifications on the shareholder's Wisconsin return). Each shareholder's Wisconsin basis will increase by \$17,500 (\$17,535 of income minus \$35 of nondeductible expenses). The Wisconsin AAA will increase to \$35,000 (\$35,070 of income minus \$70 of nondeductible expenses). The distribution of \$35,000 is nontaxable and will decrease the Wisconsin AAA to zero and each shareholder's stock basis to \$4,000.

It should be noted that for federal tax purposes, only \$30,000 of the distribution is nontaxable. The balance of the distribution is taxable as a dividend since there were accumulated earnings and profits at the end of 2004, and the federal AAA isn't increased by tax-exempt income (the \$5,000 of municipal bond interest is exempt from federal taxation).

Example 2: Assume the same facts as in Example 1, except that the corporation distributes only \$30,000 on December 31, 2005.

Each shareholder will include \$17,535 of tax-option (S) corporation income in Wisconsin income. The Wisconsin basis of each shareholder's stock will increase by \$17,500. The Wisconsin AAA will increase to \$35,000. The \$30,000 distribution is nontaxable and will decrease the Wisconsin AAA to \$5,000 and each shareholder's basis to \$6,500.

For federal purposes, \$15,000 of nonseparately stated S corporation income is includable in each shareholder's federal income. Each shareholder's federal basis will increase by \$17,500 because tax-exempt income is included for this purpose. The \$30,000 distribution, which is nontaxable, will decrease the federal AAA to zero and each shareholder's federal basis by \$15,000.

Example 3: A Delaware corporation, which had been engaged in business solely in Florida, transfers its operations and begins doing business in Wisconsin during 2005. The corporation's sole shareholder becomes a Wisconsin resident on January 1, 2005. For 2005, the corporation has net income of \$25,000 for both federal and Wisconsin purposes. The corporation distributes \$40,000 in cash to its shareholder on December 31, 2005. The corporation's federal AAA has

a \$20,000 balance on January 1, 2005. Since the corporation didn't do business in Wisconsin before 2005, its Wisconsin AAA has a zero balance on January 1, 2005.

For federal income tax purposes, the shareholder reports the \$25,000 of 2005 net income. The \$25,000 increases the federal AAA to \$45,000. The \$40,000 distribution decreases the federal AAA to \$5,000 at year-end. The distribution is nontaxable federally because it represents a distribution of previously taxed income.

For Wisconsin income tax purposes, the shareholder reports the \$25,000 of 2005 net income. The \$25,000 increases the Wisconsin AAA to \$25,000. The first \$25,000 of the distribution is nontaxable and decreases the AAA balance to zero at year-end. The \$15,000 balance of the distribution is nontaxable because it represents a distribution of income earned outside Wisconsin before the shareholder became a Wisconsin resident.

Example 4: Assume the same facts as in Example 3, except that the corporation's federal AAA has a negative \$10,000 balance on January 1, 2005, because the corporation had incurred losses in prior years.

For federal income tax purposes, the shareholder reports the \$25,000 of 2005 net income. The \$25,000 increases the federal AAA to \$15,000. The first \$15,000 of the distribution is nontaxable and decreases the federal AAA to zero at year-end. The shareholder must report the remaining \$25,000 of the distribution as a taxable dividend.

For Wisconsin income tax purposes, the shareholder reports the \$25,000 of 2005 net income. The \$25,000 increases the Wisconsin AAA to \$25,000. The first \$25,000 of the distribution is nontaxable and decreases the AAA balance to zero at year-end. The \$15,000 balance of the distribution is a taxable dividend.

Example 5: For 2005, a calendar-year tax-option (S) corporation without accumulated earnings and profits has an ordinary loss of \$10,000 and capital gain income of \$2,000 for federal and Wisconsin purposes. The corporation's sole shareholder has a federal and Wisconsin stock basis of \$9,000 on January 1, 2005. The corporation distributes \$6,000 to its shareholder during 2005.

The shareholder's federal and Wisconsin stock basis for purposes of determining the tax treatment of the distribution during 2005 is \$11,000 (\$9,000 adjusted basis on January 1 plus \$2,000 capital gain income). Therefore, the entire \$6,000 distribution is nontaxable. The nontaxable distribution reduces the shareholder's stock basis to \$5,000. The shareholder may deduct \$5,000 of the corporation's loss on the 2005 federal and Wisconsin income tax returns. This loss reduces the shareholder's stock basis to zero. The shareholder may carry over the remaining \$5,000 loss to future years.

Example 6: Assume the same facts as in Example 5, except that the corporation has \$5,000 of accumulated earnings and profits and an AAA of \$3,000 for federal and Wisconsin purposes. Since the corporation has a net negative adjustment for the 2005 taxable year, any net loss for the year is disregarded in adjusting the federal and Wisconsin AAA for purposes of determining the tax treatment of distributions made during the taxable year.

The shareholder receives a \$3,000 distribution out of the AAA and the remaining \$3,000 is treated as a dividend that reduces the corporation's earnings and profits to \$2,000 for federal and Wisconsin purposes.

The corporation's federal and Wisconsin AAA is increased by the \$2,000 capital gain and decreased by the \$10,000 ordinary loss, leaving an AAA of negative \$8,000.

The shareholder's \$9,000 federal and Wisconsin adjusted stock basis is increased to \$11,000 by the \$2,000 capital gain and reduced to \$8,000 by the \$3,000 distribution out of the AAA. The \$3,000 dividend distribution doesn't reduce the shareholder's stock basis. The shareholder may deduct \$8,000 of the corporation's ordinary loss, which reduces the shareholder's basis to zero. The shareholder may carry over the remaining \$2,000 loss to future years.

XI. SHAREHOLDER'S BASIS IN CAPITAL STOCK

Through the end of a Subchapter S corporation's 1978 taxable year, each shareholder's Wisconsin basis in the corporation's capital stock equaled the shareholder's original investment (cost or other basis) plus additional capital contributions made by the shareholder and minus distributions of capital received.

Beginning with the 1979 taxable year (the first year to which Wisconsin's tax-option (S) law applies) and through the 1986 taxable year, a shareholder's Wisconsin basis is increased (decreased) each year by the share of the corporate net income (loss), as determined under Wisconsin law, for the year.

Beginning with the 1987 taxable year, a shareholder's Wisconsin basis is increased by all items of income, including tax-exempt income, as determined under Wisconsin law. ***Taxable income must be reported on the shareholder's Wisconsin income tax return (if a return is required) for it to increase the shareholder's Wisconsin basis.***

A shareholder's Wisconsin stock basis is decreased, but not below zero, by —

- Nondeductible expenditures paid or accrued by the corporation during the year, not due to timing differences, as computed under Wisconsin law. Wisconsin's recycling surcharge and the federal excess net passive income tax are examples of nondeductible expenditures. For 1986 and prior taxable years, nondeductible expenditures included athletic or social club dues, expenses incurred on behalf of public officials, interest on the purchase of treasury stock, and payments to the spouse of a deceased officer.
- All deductible losses and deductions as computed under Wisconsin law.

Note: A shareholder may elect to decrease the stock basis by deductible losses and deductions prior to decreasing the basis by nondeductible expenses. If a shareholder makes this election, any nondeductible expenses that exceed the basis of the stock and debt owed to the shareholder by the corporation are treated as nondeductible expenses for the following taxable year. To make the election, the shareholder must attach a statement to the shareholder's timely filed original or amended return, as provided in the federal regulations. This election is effective for Wisconsin purposes unless the corporation affirmatively elects otherwise for Wisconsin purposes. Once made, the election applies to the year for which it is made and all future taxable years for the corporation, unless the Department of Revenue agrees to the revocation of the election.

- Distributions received of post-1978 taxable income (other than dividend distributions).

- The shareholder's share of the supplement to the federal historic rehabilitation tax credit computed.

When figuring the Wisconsin basis in stock of a multistate corporation, use the shareholder's pro rata share of the total company income or loss as computed under Wisconsin law. This is the shareholder's income or loss before application of either apportionment or separate accounting to arrive at the amount attributable to Wisconsin activities.

If an existing non-Wisconsin S corporation subsequently begins doing business in Wisconsin, a shareholder's Wisconsin stock basis equals the federal adjusted basis on the first day of the taxable year in which the corporation becomes subject to Wisconsin's franchise or income tax jurisdiction. At the end of that taxable year, the shareholder's Wisconsin basis is adjusted for the items of income, loss, and deduction, as computed under Wisconsin law. The initial Wisconsin stock basis is figured the same way for both residents and nonresidents of Wisconsin.

In order to be certain that no item of income, allowable deduction, or basis is included in the computation of the shareholder's net income more than once or is omitted from the computation, it is necessary to maintain a separate schedule for computing the Wisconsin basis of the tax-option (S) corporation stock.

Example 1: A corporation with two equal Wisconsin resident shareholders has federal S corporation ordinary income for its year ended December 31, 2005, of \$5,000, while its Wisconsin net income for the year is \$6,000, \$5,000 of ordinary income and \$1,000 of municipal bond interest. No distributions of income for the year are made before December 31, 2005.

Each shareholder's federal basis of corporate stock at December 31, 2005, is increased by \$3,000 (the one-half share of the \$5,000 of ordinary income and \$1,000 of tax-exempt income). The individual shareholder's Wisconsin basis of the stock at that date is increased by \$3,000 (the one-half share of the \$5,000 of ordinary income and \$1,000 of municipal bond interest).

If one shareholder sells for a profit all of the shareholder's stock in the corporation on January 1, 2006, the shareholder's gain will be the same for Wisconsin and federal purposes, if there are no other differences in basis. For federal purposes, the shareholder's share of exempt income flows through to the shareholder. Beginning with the 1987 taxable year, the Wisconsin basis of the share-

holder's capital stock is increased by the amount of any income that is exempt for Wisconsin tax purposes.

Example 2: A tax-option (S) corporation's 2005 Wisconsin net income differs from its 2005 federal S corporation income as follows:

Federal S corporation income	\$ 10,000
1. Excess of Wisconsin over federal amortization of certain deductible costs	(600)
2. Excess of Wisconsin over federal gain on disposition of assets	6,000
3. Nondeductible recycling surcharge	30
Wisconsin income	<u>\$ 15,430</u>

The corporation and its two equal Wisconsin resident shareholders report on a calendar-year basis. Each shareholder's Wisconsin basis of the corporation's capital stock was \$12,000 on January 1, 2005. The corporation has no accumulated earnings and profits.

Each shareholder will report \$5,000 of S corporation income on the 2005 federal income tax return and \$7,715 of tax-option (S) corporation income on the Wisconsin return.

If the corporation distributes \$10,000 (\$5,000 to each shareholder) on December 31, 2005, no part of this distribution is taxable for either federal or Wisconsin purposes. In this situation, each shareholder's Wisconsin stock basis is computed as follows:

Basis at January 1, 2005	\$ 12,000
Add: 1/2 of Wisconsin income	7,715
Subtract: 1/2 of nondeductible expenses	(15)
December 31, 2005, distribution	<u>(5,000)</u>
Wisconsin stock basis, December 31, 2005	<u>\$ 14,700</u>

Example 3: Assume the same facts as in Example 2, except that the S corporation had federal and Wisconsin accumulated earnings and profits of \$10,000 on January 1, 2005. Its federal Accumulated Adjustments Account (AAA) and its Wisconsin AAA both had a zero balance on January 1, 2005. The corporation distributes \$20,000 (\$10,000 to each shareholder) on December 31, 2005.

Each shareholder will still report \$5,000 of S corporation income on the 2005 federal income tax return and \$7,715 of tax-option (S) corporation income on the Wisconsin return.

The federal AAA will increase to \$10,000 while the Wisconsin AAA will increase to \$15,400 (\$15,430 of income minus \$30 of nondeductible expenses).

Of the \$10,000 distribution received by each shareholder, \$5,000 is treated as a nontaxable distribution (decreasing the federal AAA to zero) and \$5,000 is a taxable dividend for federal tax purposes. For Wisconsin, \$7,700 is a nontaxable distribution, which decreases the Wisconsin AAA to zero, and \$2,300 is a taxable dividend.

The federal accumulated earnings and profits are reduced to zero, and the Wisconsin accumulated earnings and profits are decreased by \$4,600 to \$5,400.

In this situation, each shareholder's Wisconsin basis is computed as follows:

Basis at January 1, 2005	\$ 12,000
Add: 1/2 of Wisconsin income	7,715
Subtract: 1/2 of nondeductible expenses	(15)
December 31, 2005, distribution	<u>(7,700)</u>
Wisconsin stock basis, December 31, 2005	<u>\$ 12,000</u>

Example 4: A corporation was incorporated on January 1, 2004, and its two shareholders each invested \$10,000 in exchange for equal shares of capital stock. The corporation elected to be taxed under federal Subchapter S beginning with its 2004 calendar year, and that election applies for Wisconsin purposes. The corporation does business in and outside Wisconsin. Shareholder A is a full-year Wisconsin resident and Shareholder B is a nonresident of Wisconsin.

For 2004, the corporation computes a net loss of \$8,000, of which 45% is attributable to Wisconsin. The loss reduces the Wisconsin AAA to negative \$8,000.

For 2005, the corporation computes ordinary income of \$14,000, of which 40% is attributable to Wisconsin. The income increases the Wisconsin AAA by \$14,000 to \$6,000. The corporation distributes \$1,000 to each of its shareholders on December 31, 2005. The distributions reduce the Wisconsin AAA to \$4,000.

Shareholder A will deduct \$4,000 (50% x \$8,000) of tax-option (S) corporation net loss on the 2004 Wisconsin return and will report \$7,000 (50% x \$14,000) of ordinary income on the 2005 Wisconsin return. The \$1,000 distribution Shareholder A receives on December 31, 2005, is nontaxable since it doesn't exceed the Wisconsin AAA balance or Shareholder A's Wisconsin stock basis.

Shareholder B will deduct \$1,800 (50% x 45% x \$8,000) of tax-option (S) corporation net loss on the 2004 Wisconsin return and will report \$2,800 (50% x 40% x \$14,000) of ordinary income on the 2005 Wisconsin return. The \$1,000 distribution Shareholder B receives is nontaxable by Wisconsin since it doesn't exceed the Wisconsin AAA balance or the Wisconsin stock basis and since Shareholder B is a nonresident.

Each shareholder's Wisconsin stock basis is computed as follows:

	A	B
Basis at January 1, 2004	\$ 10,000	\$ 10,000
Subtract: 1/2 of 2004 loss	<u>(4,000)</u>	<u>(4,000)</u>
Wisconsin stock basis, December 31, 2004	\$ 6,000	\$ 6,000
Add: 1/2 of 2005 income	7,000	7,000
Subtract: December 31, 2005, distribution	<u>(1,000)</u>	<u>(1,000)</u>
Wisconsin stock basis, December 31, 2005	<u>\$ 12,000</u>	<u>\$ 12,000</u>

If Shareholder B becomes a Wisconsin resident on January 1, 2006, the Wisconsin stock basis on that date will be \$12,000.

XII. ADDITIONAL INFORMATION OR FORMS

If, after reading this publication, you have any questions about the Wisconsin tax law relating to tax-option (S) corporations, you may:

- E-mail your question to corp@dor.state.wi.us
- Send a FAX to (608) 267-0834
- Call (608) 266-2772 [TTY (608) 267-1049]
- Write to the Audit Bureau, Wisconsin Department of Revenue, Mail Stop 5-144, P.O. Box 8906, Madison, WI 53708-8906
- Call or visit any Wisconsin Department of Revenue office

If you need forms, you may:

- Download forms from the Department of Revenue's Internet web site at www.dor.state.wi.us
- Use your fax telephone to call the Department of Revenue's Fax-A-Form Retrieval System at (608) 261-6229
- Request them on-line at www.dor.state.wi.us/html/formsreq.html
- Call (608) 266-1961
- Write to the Forms Request Office, Wisconsin Department of Revenue, Mail Stop 1-151, P.O. Box 8949, Madison, WI 53708-8949
- Call or visit any Wisconsin Department of Revenue office